

# OVERVIEW OF COMMON SNTs AND TAX CLASSIFICATION



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**2026 NATIONAL CONFERENCE ON SPECIAL NEEDS PLANNING AND SPECIAL  
NEEDS TRUSTS**

**STETSON UNIVERSITY COLLEGE OF LAW**

**October 21, 2026**

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## OVERVIEW OF COMMON SNTs AND TAX CLASSIFICATION

### I. The Point of This Session

Christopher Steele has just given you the 30,000-foot view of grantor and nongrantor trust taxation. At 1:00, Amy O'Hara will drill down into the tax treatment of first-party and third-party special needs trusts, including estate inclusion, gift tax, qualified disability trusts, and the finer points of grantor status. I have the fifty minutes in between.

My job is to make sure you know the basic types of special needs trusts and how (and why) they are classified for income tax purposes. There will be some overlap with Steele's session and with O'Hara's session . . . and that is fine. We intentionally designed this day to be a "basics" approach and it can be useful for someone learning the basics to hear the same rules and considerations articulated in various ways by different presenters.

That sounds easier than it is because we special needs lawyers use several different sets of labels at the same time. "first-party," "third-party," "payback," "sole benefit," "revocable," "irrevocable," "grantor" and "nongrantor" describe different characteristics. By the end of this session you'll be able to sort through these labels and classify various trusts from both public benefits and tax standpoints.

#### A. Two Different Questions

**Question One — benefits law:** Whose assets went into the trust, who may benefit, and which Medicaid or SSI rule makes the trust useful (or troublesome)?

**Question Two — income tax:** Who is treated as the tax owner of the trust or of a portion of the trust? Is the activity reported on an individual Form 1040 under the grantor trust rules, or does the trust enter the Subchapter J world and report on Form 1041?

Do not answer Question Two by looking at the title on the first page of the document. A "special needs trust" is not a tax classification. Neither is an "asset protection trust." Even "irrevocable" does not tell you whether a trust is a grantor trust.

#### THE WORKING RULE

Classify the trust twice: first for public-benefits purposes, then for income-tax purposes. Keep the two analyses in separate mental boxes until you are ready to connect them.

#### B. Words That Cause Trouble

For tax purposes, the "grantor" is generally a person who creates a trust or makes a gratuitous transfer to it. But the person who signs the document, the person whose money funds it, the beneficiary, and the person treated as the tax owner can be different people. A parent can

physically establish a D4A trust using a disabled child's money; that does not make Mom the tax owner of the child's money.<sup>1</sup>

One more warning: Medicaid and SSI materials sometimes use “grantor,” “settlor,” or “established by” in a benefits-law sense. Those words do not override Subpart E of Subchapter J. When the question is federal income tax ownership, come back to IRC §§ 671–678.

### C. Seven Trust Families

We will apply that two-question approach to the six families of trusts you are most likely to encounter in an elder and special needs practice:

- The classic first-party payback trusts, which I call D4A trusts, sometimes referred to as “payback” trusts or “self-settled” trusts.<sup>2</sup>
- Spousal sole benefit trusts under 42 U.S.C. § 1396p(c)(2)(B)(i) and (ii) (which I call B1 and B2 trusts).
- Third-party sole benefit trusts under § 1396p(c)(2)(B)(iii) and (iv) (which I call B3 and B4 trusts).
- Third-party SNTs that are not B3 or B4 trusts.
- Irrevocable first-party asset protection trusts that are not D4A trusts.
- Revocable trusts.
- Testamentary trusts, including testamentary SNTs.

I'll go over each of these in more detail below.

## II. The Sixty-Second Tax Refresher

### A. Grantor Trusts: Tax Alter Egos

As you heard in the last session, a grantor trust is a trust (or a portion of a trust) whose income-tax activity is attributed to a person treated as the owner under IRC §§ 671–678. Usually that person is the settlor who funded the trust. In the common whole-trust case, income, deductions and credits flow through to the owner and end up on the owner's Form 1040. Rev. Rul. 85-13<sup>3</sup> is the Service's long-standing ruling on this topic and essentially says that if it is a grantor trust, ignore it for all income tax purposes.

The rules in IRC §§ 673–678 are best viewed as a dashboard of switches. A reversionary interest, a power affecting beneficial enjoyment, certain administrative powers, a power to revoke, or rights to income can switch on grantor status. You do not need to memorize every switch today. You do need to know that the document controls, and sometimes only a portion

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<sup>1</sup> Treas. Reg. § 1.671-2(e)(1); see also 42 U.S.C. § 1396p(d)(4)(A).

<sup>2</sup> 42 U.S.C. § 1396p(d)(4)(A) (Get it? D4A Trust).

<sup>3</sup> Rev. Rul. 85-13, 1985-1 C.B. 184.

(say, principal or income) of the trust is switched on (often inadvertently).<sup>4</sup> I have attached a one page “Grantor Trust Cheat Sheet” you may find useful as a quick reference.

## B. Nongrantor Trusts: The Separate Taxpayer

If no person is treated as the owner under the grantor trust rules, the trust is a separate taxpayer. Form 1041 enters the picture. Very generally, income retained by the trust is taxed to the trust; taxable income carried out with distributions is ordinarily deducted by the trust and reported to beneficiaries on Schedule K-1, subject to the distributable net income rules. Christopher already did the heavy lifting on that. As I explain to clients, “When there is income on the table, the task with a nongrantor trust is to figure out who is going to pay the taxes. The trust, or the beneficiaries who received distributions?”

For today, remember only two practical points. First, trust income-tax brackets are compressed, so accumulation of income in the trust can be expensive. Second, “nongrantor” is not a synonym for “bad.” Sometimes a nongrantor trust is exactly the design you want; further, many trusts inevitably become nongrantor trusts after the person who was the grantor-tax owner dies.

## C. Portions Matter

IRC § 671 repeatedly speaks in terms of ownership of “any portion” of a trust. A trust can be grantor as to income but not principal, grantor as to one fractional share but not another, or grantor as to a particular asset (say, a residence).

The classic trap is a reserved income interest. Section 677 can make the settlor the tax owner of ordinary income while leaving capital gains allocated to principal outside that grantor portion unless another rule reaches principal. If your tax objective involves the residence exclusion under IRC § 121 or capital-gain reporting, “grantor as to income” may not be enough. But that is as close to “moderate-to-advanced” as I will get here.

### **BEGINNER’S SHORTCUT**

Whole-trust labels are convenient, but never let the shortcut make you forget the statute’s phrase “any portion.”

## D. Three Things Grantor Status Does Not Automatically Mean

- Grantor trust does not automatically mean revocable. Many intentionally defective grantor trusts are irrevocable. There are financial industry people out there you may have to explain this to.
- Grantor trust does not automatically mean the trust is an available resource for Medicaid or SSI. Tax ownership and benefits availability arise under different bodies of law. There are public benefits caseworkers out there you may have to explain this to.

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<sup>4</sup> IRC §§ 671–678.

- Grantor trust does not automatically mean estate inclusion for basis purposes. Amy will take you farther down that road this afternoon. There is a big overlap between the grantor trust rules and the estate inclusion rules, but it is not a perfect or complete overlap.

### III. D4A / Self-Settled Payback SNTs

#### A. The Benefits-Law Label

The classic D4A trust is the trust an SSI or Medicaid beneficiary uses after receiving money that would otherwise destroy means-tested eligibility: a personal-injury settlement, an inheritance that was not planned into a third-party SNT, or other windfall. The authority is 42 U.S.C. § 1396p(d)(4)(A).<sup>5</sup>

In broad terms, the trust must contain assets of a disabled individual who is under age 65 when the assets are placed in the trust; must be established through the permitted persons (now including the individual); must be for the beneficiary's sole benefit; and must contain the required Medicaid reimbursement provision. The 21st Century Cures Act removed the old requirement that a competent but disabled adult would nevertheless need to find a parent, grandparent, guardian, or court to establish the trust for her.<sup>6</sup>

The public-benefits bargain is straightforward: the beneficiary's own money can (i) fund the trust without penalty, and (ii) remain in a trust and, if properly administered, avoid resource counting; in exchange, amounts remaining at death are exposed to Medicaid reimbursement before the permitted remainder disposition.

#### B. The Tax Label: Follow the Money, Not the Signature Page

Suppose Dana receives a \$400,000 settlement. Dana's mother signs the trust as "settlor" because an old form still uses pre-Cures Act permissible settlors or perhaps Dana is incapacitated. Whose money funded the trust? Dana's. For tax purposes, the regulations treat a person who makes a gratuitous transfer as a grantor. Mom's role in creating the document does not make her the income-tax owner of Dana's \$400,000.

For a conventionally drafted, beneficiary-funded D4A trust, the practical classification is a grantor trust with respect to the disabled beneficiary. At a minimum, IRC § 677 is immediately relevant because trust income may be distributed to or accumulated for the grantor-beneficiary. The usual D4A structure also gives the trustee broad ability to use trust assets for that beneficiary (a "reversionary interest" and assuming maximum use of discretion of the trustee's part), and the grantor-trust rules under IRC § 673 will reach the trust as a whole.

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<sup>5</sup> Which provides an exception to the general OBRA '93 rule that any portion of an irrevocable self-funded trust that could under "any circumstances" be distributed to the settlor will be considered an available asset. 42 U.S.C. § 1396p(d)(3)(B). That is a harsh result if a Medicaid beneficiary directly inherits from Grandpa. D4A to the rescue.

<sup>6</sup> 42 U.S.C. § 1396p(d)(4)(A); In the SSI context, *see* POMS SI 01120.203C (special needs trusts established on or after Dec. 13, 2016).

**Bottom line:** A truly self-funded D4A SNT is a grantor trust for the disabled beneficiary. The tax return follows the beneficiary even though someone else may have established the trust.

### C. Example: The Settlement Trust

**Facts.** Sam, age 37, receives SSI and Medicaid and settles a claim for \$600,000. Sam establishes an irrevocable D4A trust. An independent trustee may make discretionary distributions solely for Sam. The document contains the required Medicaid payback language.

**Benefits** classification. First-party D4A/payback SNT under 42 U.S.C. § 1396p(d)(4)(A).

**Tax** classification. Treat Sam as the grantor-tax owner of the beneficiary-funded trust under the usual grantor-trust analysis. The fact that the trust is irrevocable and managed by someone else does not make it a nongrantor trust.

**Beginner trap.** “Irrevocable” limits Sam’s power to revoke or amend. It does not answer the income-tax ownership question. I end up explaining this to various financial professionals a number of times a year.

## IV. Spousal Sole Benefit Trusts — B1 and B2 Exceptions

### A. The Benefits-Law Label

I love these things! The first two trust-oriented transfer exceptions in 42 U.S.C. § 1396p(c)(2)(B) are marital. B1 protects a transfer to the individual’s spouse or to another for the sole benefit of that spouse. B2 protects a transfer from the individual’s spouse to another for the sole benefit of that spouse. They matter because the general transfer-penalty rule reaches transfers by both the institutionalized individual and the spouse during the look back period. But if these exceptions successfully apply, the assets conveyed to “another” (i.e., a trustee) “solely for the benefit of” the spouse do not trigger the transfer rules and render the assets non-countable.<sup>7</sup>

The statute does not define “solely for the benefit of.” Most of the rules under 42 U.S.C. § 1396p(c) and (d) involving trusts are a product of OBRA ’93. Shortly after the enactment, the Health Care Financing Authority (or HCFA, later to be CMS) released its interpretation of the statutory rules as “Part 3 – Eligibility” to the State Medicaid Manual (HCFA/CMS guidance to state Medicaid directors).<sup>8</sup> In a nutshell, to be “solely for the benefit of” the spouse the trust must provide a distribution standard that will guarantee a complete distribution *within* (not *over*) the spouse’s actuarial life expectancy (“actuarial soundness”) or provide a D4A-like payback provision.<sup>9</sup>

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<sup>7</sup> 42 U.S.C. § 1396p(c)(2)(B)(i)-(ii).

<sup>8</sup> The rest of this Outline refers to this as “Transmittal 64.”

<sup>9</sup> See Transmittal 64 § 3258 B.6.

## B. Sections 673 and 677 are your friends

Assume Husband transfers his property to an irrevocable trust solely for Wife (a B1 transfer). Or say wife transfers assets to the trust (a B2 transfer). The trustee can distribute trust income to Wife and may accumulate it for later distribution to her. Either husband or wife is the transferor and therefore a grantor for tax purposes. IRC § 677(a) says that the grantor is treated as the owner of any portion whose income may be distributed or accumulated for the grantor or the grantor's spouse, without the consent of an adverse party. Similarly, if a reversionary interest that exceeds 5% of the trust value exists (principal that could be distributed from the trust within the trustee's discretion -- assuming maximum discretion) could trigger grantor trust status under IRC § 673.

## C. Tax Ownership Is Not Medicaid Availability

A tax conclusion that a spouse is the grantor-tax owner under either IRC §§ 673 or 677 does not, by itself, mean the SBT principal is an available Medicaid resource to the community spouse. Conversely, benefits-law restrictions that keep trust assets from being countable do not force nongrantor tax treatment.

These trusts are wonderful tools for transferring highly appreciated assets that pose great difficulties for standard Medicaid strategies to a B1 or B2 trust and getting them “off the benefits board” without triggering dire tax consequences.

## D. Example: Institutionalized Husband, Community Spouse Wife

**Facts.** Henry is entering a nursing facility. His wife, Wilma, remains at home. Wilma transfers assets to an irrevocable trust for Wilma that is intended to satisfy the B2 sole-benefit exception. The trustee must make actuarially sound distributions for Wilma and may distribute additional amounts for her benefit (remember “within” not “over” her life expectancy).

**Benefits classification.** Spousal sole benefit trust under B2. Transfer not sanctionable and assets not countable.

**Tax classification.** Wilma is the funding grantor. Because income may be paid or accumulated for her, and because assets constitute a “reversionary interest” that could be distributed to her within trustee discretion, IRC §§ 673 and 677 point to grantor status for the income portion. Determine whole-trust status from the rest of the instrument.

**The Beauty.** What if the assets were highly appreciated gold coins or LLC membership interests? No need to liquidate and incur capital gains tax. Transfer in-kind. No taxes because it is a grantor trust.

**Beginner trap.** Again, do not call the trust “nongrantor” merely because it is irrevocable and designed to protect assets for Medicaid purposes.

## V. Third-Party Sole Benefit Trusts — B3 and B4 Exceptions

### A. The Benefits-Law Label

B3 and B4 trusts are the nonspousal sole-benefit trust exceptions. B3 covers a transfer to, or to a trust established solely for the benefit of, the individual's blind or disabled child. There is no age ceiling for the child. B4 covers a transfer to a trust established solely for the benefit of a disabled individual under age 65.<sup>10</sup>

Why do we care? Because the transferor may be the person planning for his or her own future Medicaid eligibility. A properly structured SBT can allow a sanction-free transfer for the protected beneficiary and, as we will see, can avoid a payback provision. That is what distinguishes it from a garden-variety third-party SNT funded by a parent who has no concern about the parent's own lookback period.

### B. "Solely for the Benefit Of"

The statute does not provide any definition of "solely for the benefit of." Rather, Transmittal 64 supplies the administrative framework: no other person may benefit during the applicable period, and the distribution arrangement generally must be "actuarially sound." Transmittal 64 explains that "actuarial soundness" means a choice between either a D4A "pay back" provision *or* a distribution standard that will guarantee complete trust distribution *within*<sup>11</sup> the beneficiary's actuarially determined life expectancy.<sup>12</sup>

### C. The Tax Label: Start With Nongrantor

For this Basics Level session, the safest working presumption (in my opinion) is that a true B3/B4 sole-benefit trust funded by a third party is a nongrantor trust. Why? The usual grantor-trust switches depend on retained benefits or powers in the transferor or a cooperative nonadverse person. The sole-benefit design makes me cautious about giving the *transferor* anything that might be viewed as a current benefit from or impermissible control over the transferred assets.

My own advanced outline takes the conservative position that a sole-benefit trust should not be designed as a grantor trust. There is a respectable practitioner counterpoint that a carefully drafted administrative power (most often a power of substitution under IRC § 675(4)(C)) may trigger grantor status without violating the benefits-law sole-benefit requirement. That is exactly the sort of issue that belongs in a Level II discussion.

**Beginner rule:** If the document says "B3/B4 Sole Benefit Trust," do not assume the donor is the tax owner. Begin with nongrantor treatment unless you can identify an actual grantor trust switch under IRC §§ 673-677.

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<sup>10</sup> 42 U.S.C. § 1396p(c)(2)(B)(iii)-(iv).

<sup>11</sup> Note: "Within" NOT "over."

<sup>12</sup> Transmittal 64 §§ 3257 B.6, 3258.9B.

#### D. Qualified Disability Trust: A Tax Consideration

A nongrantor trust established for disabled beneficiaries may potentially qualify for the special exemption under IRC § 642(b)(2)(C). The statute ties the definition to a disability trust described in 42 U.S.C. § 1396p(c)(2)(B)(iv) and imposes additional requirements. If the trust qualifies (and a B3 through B4 Trust should), the increased exemption may take much of the nongrantor trust tax sting out. Amy will likely address this in more detail after lunch.

#### E. Example: Mom's Medicaid Planning for Disabled Daughter

**Facts.** Mom is headed to the nursing home. Her adult daughter, Denise, has been disabled since childhood and receives SSDI but not SSI.<sup>13</sup> Mom transfers \$250,000 to an irrevocable trust solely for Denise, with actuarially sound distribution provisions and no Medicaid payback provision. Denise's children are named as the remainder beneficiaries upon Denise's death.

What if Denise is on SSI? We cannot discuss SSI qualification rules in this session other than to say there are strict income limits and \$2,000 countable asset limits under SSI. Does this absolutely rule out a B3 or B4 Trust? Not necessarily. Look at how much is funding the trust and calculate how much an annual "actuarially sound" distribution would be, then consider whether there are distributions that could be made to or for the benefit of the beneficiary that would not jeopardize SSI eligibility. Medical expenses? Food? Transportation? Clothing?

For example, if Denise is 45, the Social Security Administration 2023 Life Table says she has a 38.01 year life expectancy. If the trust term is set at 38 years and the trust formula says the year one minimum distribution must be  $1/38^{\text{th}}$  of the trust, that works out to around \$6,579. Can the trustee come up with some creative items to purchase or services to acquire for Denise?

**Benefits classification.** A B3 sole-benefit trust can fit the transfer exception for a disabled child. If Denise was not disabled, but rather her husband Don was the disabled individual, Mom could establish a B4 Trust for her son-in-law as long as he is under age 65. All the other B3 planning considerations apply.

**Tax classification.** Begin with nongrantor trust treatment. The trustee files Form 1041 and the usual Subchapter J rules determine whether taxable income stays in the trust or is carried out to Denise.

**Beginner's Tip:** Always ask if there are any disabled family members in an initial client meeting.

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<sup>13</sup> Because this is Basic Level: SSDI does not have the stringent Medicaid-like asset and income rules that SSI does, so distributions to disabled daughter are not too much of a planning concern.

## VI. “Garden-Variety” Third-Party SNTs

### A. Not Every Third-Party SNT Is a Sole Benefit Trust

Parents and grandparents routinely create discretionary SNTs for a disabled family member without any concern about the transferor qualifying for Medicaid. In that setting, the trust does not need the B3/B4 transfer exception. It simply needs to avoid making trust assets an available resource to the beneficiary and to coordinate distributions with SSI or Medicaid rules if those benefits matter.

This distinction is important. A parent who is 52 years old with ample retirement assets may have no reason to accept the actuarially sound distribution structure of a sole benefit trust. A purely discretionary third-party SNT may be the better benefits design.

### B. Tax Classification Is a Design Choice

Unlike the B3/B4 SBT, a garden-variety third-party SNT can readily be drafted as either a grantor or nongrantor trust while the donor is alive. If Dad retains a non-excepted power to affect beneficial enjoyment, a substitution power, or another appropriate Subpart E grantor trust switch, Dad may be the tax owner. If the trust is drafted without a grantor-trust trigger, the trust is a nongrantor taxpayer.

The choice is strategic. Grantor treatment can simplify income-tax reporting and permit the donor to pay the tax — effectively allowing the trust to grow without using trust assets for income taxes. Nongrantor treatment can isolate income from the donor and may position the trust for the qualified disability trust exemption if the statutory requirements are met. Pick your design poison.

### C. Be Careful of HEMS Distribution Standards

Whatever tax classification you choose, a third-party SNT for a means-tested-benefit recipient should not use an enforceable support or HEMS standard. An “ascertainable” or “health, education, maintenance, or support” standard imposes mandatory distribution standards on the trustee and will result in the trust being a countable asset to the beneficiary.<sup>14</sup> If you see a trust intended to be a trust for a disabled beneficiary drafted with a HEMS distribution standard, you can reasonably assume the scrivener did not know what he or she was doing. By the way, this same concern applies to testamentary trusts.

### D. After the Donor Dies

A grantor trust does not stay a grantor trust forever simply because it began that way. When Dad dies, there is no longer a living Dad to be the owner under IRC §§ 673–677. The continuing trust ordinarily becomes a nongrantor trust unless it was a joint trust with Mom or another person is treated as owner under a rule such as IRC § 678 (a topic for another day).

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<sup>14</sup> See POMS SI 01120.200.D.1.

That transition is one reason an attorney who drafts lifetime third-party SNTs needs at least a working understanding of both grantor and nongrantor tax schemes. You may be drafting a trust that uses Form 1040 for ten years and Form 1041 for the next forty.

## VII. Irrevocable First-Party Asset Protection Trusts

### A. Not a D4A Trust

Gloria, age 68, transfers her residence and investment assets to an irrevocable trust. She is not trying to preserve Medicaid at this time. The trust prohibits any distribution of principal to Gloria but may reserve income to her or permit distributions to children. She hopes to get through the Medicaid lookback period while protecting principal from future nursing-home spend-down.

That is a first-party irrevocable asset protection trust, but it is not a D4A trust because it is not necessarily solely for her benefit nor does it contain a payback provision. Because principal cannot be paid to Gloria, the principal will be unavailable under the self-settled trust rules; because she transferred assets for less than fair market value, the transfer rules and five-year lookback then become critical.

The statute says that “if there any circumstances” a distribution could be made to or for the benefit of Gloria, then that “portion” can be counted (in most cases the “portions” refers to either principal or income). If income could be distributed to Gloria, Medicaid will count the income; if there are no circumstances in which principal could be distributed to Gloria, the principal will not be countable, but the trust funding will be subject to Medicaid transfer sanctions review.

### B. Tax Label: Pick Your Strategy

You can design the trust either way. Start with an irrevocable trust containing no retained tax powers, then deliberately add the switch you want — or leave all switches off.

**Grantor design.** A carefully selected IRC § 674 or § 675 power can produce grantor status without giving Gloria a property right to receive principal. A retained income interest under IRC § 677 produces grantor treatment as to the income portion, but that alone might not create a grantor trust with respect to principal (causing potentially painful capital gains problems at the trust level).

If you want grantor trust treatment at the principal level consider a power of substitution under IRC § 675(4)(C). Concerned this could cause Medicaid problems? Rationally it should not, but do state programs always act rationally? If it is a concern simply give the power to a nonadverse party (Maybe Gloria’s brother?).

**Nongrantor design.** If the trust avoids grantor trust status, then it becomes a separate taxpayer. That may be acceptable or desirable, but the compressed trust brackets and capital-gain rules deserve attention and will be addressed more fully in a later session.

**Partial grantor** design. The rules can be applied to portions. In a sophisticated design, the residence might be within a grantor portion while other assets are not, although added complexity should have a reason.

#### C. Why You Might Want Grantor Status

- Administrative simplicity: tax activity can continue on the settlor's Form 1040 instead of creating a full separate taxpayer during life.
- Preserving tax attributes tied to the owner, such as the potential IRC § 121 principal-residence capital gains exclusion when the regulations treat the grantor as owner of the residence.
- Allowing the settlor to bear the income-tax cost rather than depleting trust assets, assuming the overall planning design supports that result.

#### D. Why You Might Want Nongrantor Status

- The client may deliberately want income separated from the client's return or may not want to bear the trust's income tax.
- The nature of the assets and anticipated distributions may make the compressed brackets less important than expected.
- Avoiding a grantor switch can simplify the benefits-law drafting where a retained or delegated power might create an availability argument.

#### E. Example: Residence Plus Brokerage Account

**Facts.** Gloria transfers a \$500,000 residence and \$300,000 brokerage account to an irrevocable trust. She retains a mandatory right to accounting income but no right to principal. The trust gives an appropriate nonadverse person a separate power intended to cause grantor status as to principal.

**Benefits classification.** First-party irrevocable asset protection trust; not D4A. Principal availability and the transfer/lookback consequences must be analyzed under 42 U.S.C. § 1396p(c) and (d).

**Tax classification.** Do not stop at the IRC § 677 the reserved income right. Confirm that a separate power actually reaches principal if whole-trust grantor status is the objective.

**Beginner trap.** "The trust pays all income to the settlor, so it is a grantor trust" is not necessarily accurate. Ask: grantor as to what portion? I have seen trusts drafted with a retained income right only and with a residence in trust (good luck with the sale of the residence!).

## VIII. Revocable Trusts

### A. The Easy One

A conventional revocable living trust is a grantor trust while the person holding the power to revest title is alive. IRC § 676 supplies the answer: if the grantor or a nonadverse party can revest title to a portion of the trust in the grantor, the grantor is treated as the owner of that portion.<sup>15</sup>

Client establishes and funds a fully revocable living trust for herself? Grantor trust. The assets and income continue to be reported as the client's for all federal income-tax purposes.

### B. Benefits Law Is Equally Unexciting

A revocable trust funded with the Medicaid applicant's own assets does not shelter those assets. If the applicant can revoke the trust and take the property back, the property is available. That is why a standard probate-avoidance revocable trust is not a Medicaid asset-protection trust.<sup>16</sup>

### C. Death Changes the Taxpayer

I like that heading! It certainly does (change the taxpayer)! At the grantor's death, the power to revoke dies with the grantor. A continuing trust normally becomes a nongrantor trust and begins using Form 1041, subject to the terms of the post-death trust and any other owner rule that might apply. For a joint revocable trust, one spouse's death may produce a more complicated split between the survivor's grantor portion and a decedent's nongrantor portion. Spot the issue; do not assume the pre-death tax label survives unchanged.

## IX. Testamentary SNTs

### A. Tax Label: Nongrantor

A testamentary trust is created under a decedent's will. The person whose will created it is dead.<sup>17</sup> Accordingly, there is no living settlor who can remain the tax owner under IRC §§ 673–677. The trust is a nongrantor trust and operates under the usual Subchapter J rules unless some beneficiary or other person is treated as owner under IRC § 678.

If you do estate planning, elder law, or anything having to do with testamentary trusts, you already deal with nongrantor trusts whether you think of yourself as a “trust tax lawyer” or

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<sup>15</sup> IRC § 676(a).

<sup>16</sup> 42 U.S.C. § 1396p(d)(3)(A). Interesting point. As written, the statute says assets in a revocable trust are countable resources. Period. Many states (*e.g.*, North Carolina) take the “see-through” view and count assets in a revocable trust that would otherwise be countable and do not count otherwise noncountable assets. The literal wording of the statute would present a wonderful planning opportunity: Transfer the residence to the trust and make it countable. Apply for Medicaid. Remove the residence from trust as part of the spenddown strategy. I think the statute was poorly drafted.

<sup>17</sup> I didn't even have to go to law school to figure that out.

not. The basic tax regime is really not that difficult to understand. Now if you want to be an expert . . . .

## B. Benefits-Law Advantage for a Spouse

Testamentary trusts are an incredibly important tool in an elder law practice. The self-settled trust rules in 42 U.S.C. § 1396p(d)(2)(A)<sup>18</sup> (remember the “under any circumstances” rule?) apply to trusts established by the individual or spouse “*other than by will*.” A trust created under the will of a deceased spouse is therefore outside that statutory definition and is analyzed more like a third-party trust (remember the “is the trustee under a legal obligation” rule?). This can be extraordinarily important when planning for a surviving spouse who may need means-tested benefits.

**Tip:** Do not ever let a community spouse and an institutionalized spouse get away from you with simple “I Love You” wills. In any event, the community spouse should at least have a will with a testamentary trust for the surviving institutionalized spouse in case the CS is hit by a school bus.

## C. Testamentary SNT Example

**Facts.** Dad’s will leaves Daughter’s share in a purely discretionary SNT. Daughter receives SSI and Medicaid. Dad dies and the executor funds the trust.

**Benefits classification.** Third-party testamentary SNT; analyze the distribution standard under the third-party trust rules (if purely discretionary distribution standard, great).

**Tax classification.** Nongrantor trust. The trustee files Form 1041, and distributions may carry DNI to Daughter on Schedule K-1.

**Tax issue to spot.** Depending on the beneficiaries and terms, ask whether the trust may qualify as a qualified disability trust under IRC § 642(b)(2)(C). Amy will take it from there.

## X. Putting the Labels Together

### A. The Same Tax Label Can Sit on Very Different Benefits Trusts

A beneficiary-funded D4A trust and a revocable living trust can both be grantor trusts, even though one is irrevocable, contains Medicaid payback, and exists to preserve needs-based benefits while the other is fully revocable and offers no Medicaid protection at all. The shared tax label tells you only who reports the income.

Likewise, a testamentary SNT and a properly drafted B3 sole-benefit trust can both be nongrantor trusts even though one springs into existence at death and the other is created during life to fit a transfer-penalty exception. Again, the shared tax label does not erase their benefits-law differences.

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<sup>18</sup> See, also, Transmittal 64 § 3259.3.

## B. The Same Benefits Label Can Carry Different Tax Results

“Third-party SNT” is a benefits-law description. During Dad’s life it can be intentionally grantor as to Dad; another family’s otherwise similar trust can be nongrantor from inception. After Dad’s death, the first trust can change tax classification even though its benefits-law purpose remains exactly the same.

## XI. The Practitioner’s Four-Step Classification

- Identify the funding source. Whose assets actually went into the trust? Do not confuse the person signing the agreement with the person making the transfer.
- Identify the benefits-law rule. D4A exception? B1/B2 spousal sole-benefit exception? B3/B4 nonspousal sole-benefit exception? Ordinary third-party trust? Self-settled irrevocable trust? Revocable trust?
- Identify the tax-owner switch. Check IRC §§ 673–678 and determine whether the entire trust or only a portion is owned by a grantor or another person.
- Only then address the downstream tax consequences: Form 1040 versus Form 1041, DNI and distributions, QDT status, capital gains, basis and estate inclusion. Those are getting into more advanced topics.

## QUICK CLASSIFICATION CHART

| Trust type                                     | Whose money?                         | Level I income-tax starting point                                               | The trap to avoid                                                                                         |
|------------------------------------------------|--------------------------------------|---------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------|
| D4A / payback SNT                              | Disabled beneficiary's own assets    | Grantor trust for beneficiary (conventional self-funded case)                   | "Someone else established it, so that person is the tax owner."                                           |
| Spousal SBT — B1/B2                            | Either spouse's assets               | Grantor                                                                         | Calling the whole trust nongrantor because it is irrevocable.                                             |
| Third-party SBT — B3/B4                        | Parent/other transferor's assets     | Begin with nongrantor; identify an actual grantor switch before changing answer | Assuming "third-party" automatically means either grantor or nongrantor trust.                            |
| Garden-variety third-party SNT                 | Parent/grandparent/other third party | Can be grantor or nongrantor by design during donor's life                      | HEMS standard                                                                                             |
| First-party irrevocable asset-protection trust | Client's assets                      | Can be grantor, nongrantor, or partial grantor by design                        | Relying on an income-only § 677 trigger when the tax objective requires principal/capital-gain ownership. |
| Revocable living trust                         | Grantor's own assets                 | Grantor trust under § 676                                                       | Thinking probate avoidance equals Medicaid asset protection.                                              |
| Testamentary SNT                               | Decedent's estate funds at death     | Nongrantor trust                                                                | When planning, forgetting the spouse-by-will exception in § 1396p(d)(2)(A).                               |

## TEN THINGS TO REMEMBER BEFORE LUNCH

1. Classify twice: benefits law first, income tax second.
2. Follow the money. The person who signs or “establishes” the document is not necessarily the income-tax grantor.
3. A conventional beneficiary-funded D4A/payback trust is a grantor trust for the disabled beneficiary.
4. A spousal SBT commonly triggers §§ 673 and 677 grantor status.
5. For a B3/B4 third-party sole-benefit trust, begin with nongrantor treatment.
6. An irrevocable first-party asset-protection trust can be grantor or nongrantor. That is a design decision, not a consequence of the word “irrevocable.”
7. A revocable living trust is the easy one: § 676 makes it a grantor trust while the revocation power exists.
8. A testamentary trust is a nongrantor trust, and a spouse’s testamentary trust also gets a critical benefits-law advantage under § 1396p(d)(2)(A) if properly drafted as a purely discretionary trust.
9. Grantor status does not automatically mean Medicaid availability
10. Grantor status does not automatically guarantee estate inclusion. The rules are similar, but not identical.

## GRANTOR TRUST CHEAT SHEET



### Grantor Trust Powers (One Page Cheat Sheet)

|            |                                                                                                                                                                                                                                                                                                                                           |
|------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>673</b> | Reversionary interest = 5% or more; Maximum trustee discretion assumed                                                                                                                                                                                                                                                                    |
| <b>674</b> |                                                                                                                                                                                                                                                                                                                                           |
| (b)(1)     | Provision allowing income to legal support obligation OK; Actually do it – grantor trust                                                                                                                                                                                                                                                  |
| (b)(2)     | Postponed power as long as less than 5%                                                                                                                                                                                                                                                                                                   |
| (b)(3)     | Testamentary power unless income accumulation                                                                                                                                                                                                                                                                                             |
| (b)(4)     | Allocate among charitable beneficiaries                                                                                                                                                                                                                                                                                                   |
| (b)(5)(A)* | Distribute <u>corpus</u> among beneficiaries if subject to reasonably definite standard                                                                                                                                                                                                                                                   |
| (b)(5)(B)* | Distribute <u>corpus</u> to income beneficiaries as long as chargeable to donee share                                                                                                                                                                                                                                                     |
| (b)(6)*    | Power to distribute or accumulate <u>income</u> to any income beneficiary as long as: <ul style="list-style-type: none"> <li>• Ultimately payable to THAT beneficiary or his assignees or estate, OR</li> <li>• Added to corpus and distributed to current income beneficiaries in irrevocably specified shares on termination</li> </ul> |
| (b)(7)*    | Withhold income during incapacity                                                                                                                                                                                                                                                                                                         |
| (b)(8)     | Reasonable allocations between principal and income                                                                                                                                                                                                                                                                                       |
| (c)*       | Independent trustees can accumulate, distribute corpus or income among beneficiaries or class of beneficiaries                                                                                                                                                                                                                            |
| (d)*       | Trustee (other than grantor or spouse) can accumulate/distribute income among beneficiaries if subject to reasonably definite standard                                                                                                                                                                                                    |
| <b>675</b> | Admin Powers: Bargain dealing, great loans for grantor or nonadverse; grantor borrows and fails to repay before years end (unless trustee Independent); Power of Substitution                                                                                                                                                             |
| <b>676</b> | Power of revocation in grantor or nonadverse party                                                                                                                                                                                                                                                                                        |
| <b>677</b> | Income distributed or accumulated for grantor or grantor's spouse                                                                                                                                                                                                                                                                         |
| <b>678</b> | Someone other than grantor                                                                                                                                                                                                                                                                                                                |

\* No one may have the power to add to a beneficiary or class unless for after-born/after-adopted