

Understanding Tax Treatment for SNTs

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Framework for Analyzing Taxation of SNTs

Tax planning is an important part of establishing and administering a special needs trust (SNT). While preserving public benefits is one of the main concerns, trustees must also consider how the trust's income is reported, whether funding the trust creates a completed gift, and whether the trust assets will be included in the donor's or beneficiary's gross estate for determining estate tax liability at death. These questions arise throughout the planning process and must be understood at the outset of when the SNT is established.

The starting point is identifying whose assets are funding the trust. A first-party SNT is funded with the beneficiary's own property. Common examples include personal injury settlement proceeds, an inheritance payable outright to the beneficiary, retroactive benefits, and child support. The ownership of the property controls this determination, even when someone else establishes the trust on the beneficiary's behalf. A third-party SNT, on the other hand, is funded with another person's property that never belonged to the beneficiary. The most common example is creating and funding this type of trust as part of a parent's estate plan. A properly structured third-party SNT is not subject to the federal Medicaid payback requirement applicable to a first-party SNT.

Four separate analyses are necessary: income tax, gift tax, estate tax, and public benefits. For income tax purposes, the trustee must identify the person treated as the owner under the grantor trust rules or determine how a nongrantor trust's income will be allocated between the trust and beneficiary. The gift tax analysis addresses whether the transfer is complete. The estate tax analysis addresses inclusion at death and the related consequences for basis, deductions, and filing obligations. Public benefits eligibility requires its own review of resource availability and distributions.

These rules can produce results that initially seem inconsistent. A trust may be disregarded as a separate taxpayer for income tax purposes while its assets remain fully includable in the beneficiary's gross estate. Similarly, income taxable to the beneficiary does not necessarily constitute income for SSI or Medicaid purposes.

First-Party SNTs

Grantor Trust Reporting

A first-party SNT established under 42 U.S.C. § 1396p(d)(4)(A) holds assets originally belonging to an individual with a disability. To qualify for this type of exception trust, the trust must be irrevocable and established for that individual's benefit by the individual, a parent, grandparent, legal guardian, or court. The individual must be disabled within the meaning of the Social Security Act and under age 65 when the trust is established and funded. The trust must also provide that, upon the beneficiary's death, any remaining assets will reimburse the state Medicaid agencies, up to the total Medicaid assistance paid on the beneficiary's behalf.

First-party SNTs are typically grantor trusts for federal income tax purposes because the grantor (i.e., the beneficiary) retains the right to the beneficial enjoyment of the trust assets, even though the distribution of the trust assets are not within the beneficiary's control. When the beneficiary is treated as the owner of the trust, the trust's income, deductions, and credits are reported as though earned or incurred directly by the beneficiary. The trust is not a separate taxpayer entity.

The beneficiary is taxed on the income whether it is distributed or retained in the trust. This treatment is often advantageous because individual income tax brackets are less compressed than those applicable to nongrantor trusts, although the actual result depends on the beneficiary's income and circumstances. For 2026, a trust reaches the top 37% federal income tax bracket once its taxable income exceeds \$16,000 whereas a single individual does not reach that bracket until taxable income exceeds \$640,600.

The trustee may pay the beneficiary's income tax liability attributable to trust income. The trustee should coordinate those payments with the beneficiary and maintain sufficient cash for estimated taxes and any balance due. Taxable income and countable income for public benefits remain separate questions; the fact that trust income appears on the beneficiary's tax return does not, by itself, establish that it is countable for SSI or Medicaid.

Income Tax Reporting

The reporting method should be determined when the trust is funded. Treasury Regulation § 1.671-4 permits different methods depending on the circumstances. The trustee may file Form 1041 with a grantor trust information statement, or an eligible trust

may use an alternative reporting method. Depending on the method selected, reporting may use either the beneficiary's Social Security number (SSN) or the trust's employer identification number (EIN). A separate EIN is therefore not required for the first-party SNT, although many trustees obtain one to keep the trust's accounts and tax reporting distinct from the beneficiary's personal accounts.

Because the beneficiary is treated as the owner of the first-party SNT, the trustee provides the beneficiary and tax preparer with a grantor trust statement showing the income, deductions, and credits to report on the beneficiary's individual return. The beneficiary does not receive a Schedule K-1, and distributions do not determine how much trust income the beneficiary reports. Grantor trust reporting and nongrantor trust DNI reporting are different systems. The trustee must provide the beneficiary and tax preparer with the necessary information and coordinate account registration, Forms 1099, and return preparation.

For example, assume a first-party SNT holds a \$1 million settlement, earns \$28,000 in taxable interest and dividends, realizes \$12,000 in capital gain, and pays \$15,000 for the beneficiary's expenses. The beneficiary reports the \$40,000 of income and gain, with each item retaining its tax character and subject to applicable individual income tax rules. The amount reported is not limited to the \$15,000 spent by the trustee. Retaining the remaining income or sale proceeds in the trust does not avoid the beneficiary's income tax obligation.

Gift Tax Considerations

Funding a first-party SNT with the beneficiary's own assets is an incomplete gift when the trust permits distributions only for the beneficiary during life and directs any assets remaining after Medicaid reimbursement to the beneficiary's estate. Although the trustee controls distributions, no other person other than the beneficiary receives a beneficial interest during the beneficiary's life. Because the beneficiary has not made a completed gift, funding the trust does not trigger gift tax nor filing of a gift tax return.

Estate Inclusion

The same retained lifetime benefit that leaves the gift incomplete also informs the estate tax analysis upon beneficiary's death. First-party SNT assets are included in the beneficiary's gross estate under IRC § 2036 because of the beneficiary's retained lifetime enjoyment of the transferred property. Income tax grantor status does not establish estate inclusion. Similarly, estate inclusion does not mean that the beneficiary could compel distributions during life or that the trust is an available resource for determining Medicaid eligibility.

Trust property included in the beneficiary's gross estate receives a basis adjustment under IRC § 1014, commonly called a "step-up in basis" when the property has appreciated. The adjustment can also reduce basis if the property has declined in value. For appreciated property that qualifies for a basis adjustment, the new basis is its date-of-death fair market value. This eliminates the gain from appreciation before death and if the property is sold for that value, no capital gains tax is due on the sale. Appreciation after death is taxable when the property is sold.

The trustee should obtain and retain date-of-death valuations even when no federal estate tax return is required. Each asset's tax character must also be identified. Income in respect of a decedent, including many retirement benefits, does not receive a basis adjustment under IRC § 1014 and requires separate treatment.

Medicaid Reimbursement and Administration at Death

At the beneficiary's death, the trustee must reimburse the state Medicaid agencies before distributing the remaining trust assets, if any, to the remainder beneficiaries, which is typically to the personal representative of the beneficiary's estate. Before reimbursement, the trust can pay taxes arising from the beneficiary's death and reasonable costs of closing the trust, including final trustee fees. Funeral expenses, the beneficiary's other debts, and distributions to the estate must wait until Medicaid has been reimbursed.

The Medicaid payback does not reduce the value of the SNT included in the beneficiary's gross estate. The gross estate reflects the full date-of-death value of the trust assets, even though part of those assets must be used to reimburse Medicaid. The Medicaid claim is then deducted under IRC § 2053 in calculating the taxable estate. The beneficiary's personal representative is responsible for preparing and filing a federal estate tax return if the gross estate, together with adjusted taxable gifts and any applicable specific exemption, exceeds the filing threshold for the year of death.

Estate Tax Filing Example

Assume a beneficiary who is a U.S. citizen dies in 2026 with \$17 million in a first-party SNT and a \$5 million Medicaid reimbursement obligation. For purposes of this

example, assume the entire trust is included in the beneficiary's gross estate, the full Medicaid obligation qualifies for deduction under IRC § 2053, the beneficiary has no other includable assets or prior taxable gifts, and the full \$15 million federal basic exclusion amount is available.

The gross estate includes the entire \$17 million trust. After deducting the \$5 million Medicaid obligation, the taxable estate is \$12 million, before any other allowable deductions. Under these assumptions, no federal estate tax is payable because the taxable estate is below the available \$15 million exclusion.

Form 706 is nevertheless required. The filing requirement is based on the gross estate, taking into account the applicable adjustments for lifetime gifts, rather than the taxable estate after deductions. Here, the \$17 million gross estate exceeds the \$15 million filing threshold even though the Medicaid deduction eliminates the federal estate tax liability. State estate tax filing requirements must also be considered separately.

Third-Party SNTs

Retained Powers

A third-party SNT funded by a parent or other donor can be either revocable or irrevocable. If the donor can revoke the trust and recover its property, the donor is treated as the income tax owner. The contribution is an incomplete gift, and the retained power causes estate inclusion at the donor's death. In practical terms, placing assets in a revocable SNT does not remove them from the donor's estate. The donor reports the trust's income on their individual tax return and pays any tax due. At the donor's death, the trustee and tax preparer should separate income reportable by the donor before

death from income earned by the trust afterward and determine the trust's filing and taxpayer identification number requirements.

An irrevocable SNT can be drafted as a grantor trust if the donor retains certain powers. For example, a parent can make a completed gift to an irrevocable third-party SNT while retaining a properly structured power to substitute trust assets for assets of equal value (IRC § 675(4)(C)). That power can make the parent responsible for income tax on the portion of the trust the parent funded. Paying the tax is not another gift to the beneficiary, and it can reduce the parent's estate over time without reducing the trust's assets. The trust therefore keeps its full investment returns while the parent pays the income tax from their personal funds. Whether the trust assets are included in the parent's estate is a separate question based on the rights and powers the parent retained. If the assets are outside the parent's estate, they do not receive a basis adjustment at the parent's death merely because the parent paid tax on the trust's income.

Completed Gifts and Annual Exclusion Planning

A gift is complete when the donor gives up the ability to take the property back or decide who ultimately receives it, often through a limited power of appointment. If the donor retains either power, the transfer remains incomplete to the extent the donor still controls the property or its disposition. Calling the trust "irrevocable" does not answer the gift tax question; the trust's actual terms control. The trustee should keep a clear record of who contributed each asset, when it was transferred, and its value at that time. Counsel should also identify any powers the donor retained and determine who is

responsible for filing a gift tax return. The gift tax annual exclusion is available only when the recipient has an immediate right to use or enjoy the gift. For 2026, the exclusion is \$19,000 per donor, per recipient, but it applies only to gifts the recipient has an immediate right to use or enjoy. A beneficiary of a third-party SNT has no right to demand a distribution, so a contribution to that trust does not qualify for the annual exclusion on the basis of the beneficiary's discretionary interest. A *Crummey* power gives the beneficiary a temporary right to withdraw a contribution. That right can turn the contribution into a present interest gift for tax purposes, but it conflicts with the central protection of an SNT: keeping trust funds beyond the beneficiary's control. During the withdrawal period, funds the beneficiary has a legal right to obtain can be treated as an available resource for SSI and can affect Medicaid eligibility. The problem exists even if the beneficiary never exercises the power. A third-party SNT for a beneficiary receiving means tested benefits should not give that beneficiary a *Crummey* withdrawal power. The donor can instead make a completed gift to the SNT, file a gift tax return, and apply available lifetime exclusion. That approach preserves the trustee's control over distributions without giving the beneficiary an enforceable right to trust funds.

Qualified Disability Trusts

A qualified disability trust (QDisT) receives a larger federal income tax exemption when it meets the requirements of IRC § 642(b)(2)(C). To qualify as a QDisT, the trust must be a nongrantor trust established solely for the benefit of a person with a disability who was under age 65 when the trust was established. The beneficiary at the close of the tax year must have been determined by the Social Security Administration to be disabled for at least part of that year. A remainder beneficiary who receives trust

property only after the trust no longer has a disabled beneficiary does not prevent qualification. The trustee should retain the disability determination.

A grantor trust cannot use the QDisT exemption because its income is reported by the grantor, not taxed to the trust as a separate taxpayer. For first-party SNTs, the beneficiary is treated as the income tax owner of the entire trust and reports the trust's income on the beneficiary's individual return. There is no trust level income against which to apply the QDisT exemption. The QDisT analysis is therefore unnecessary for a first-party SNT that is wholly a grantor trust.

For 2026, a QDisT receives a \$5,300 income tax exemption, which reduces the amount of trust income subject to tax. By comparison, a complex trust receives a \$100 exemption, while a simple trust required to distribute all its income currently receives a \$300 exemption (which should never be a SNT). The exemption reduces taxable income but does not change the trust tax brackets. The 37% federal rate applies to trust taxable income above \$16,000 in 2026.

For example, a mother's last will and testament bequests \$1.5 million to a third-party SNT for her 40-year-old daughter, who receives SSDI. The trust is funded with the mother's assets after her death, and the daughter is under age 65 when it is established. If the trust is solely for the daughter's benefit, is taxed as a nongrantor trust, and meets the QDisT disability requirements, the trustee claims the QDisT exemption on Form 1041. The trustee should retain the daughter's Social Security disability determination to support that filing position. The exemption reduces the income taxed to the trust. It does not determine whether distributions are taxable to the

daughter; the trustee and tax preparer must analyze those distributions under the separate DNI rules.

Distributable Net Income

Distributable net income, or DNI, determines how much of a nongrantor trust's income is taxed to the beneficiary when the trust makes a distribution. The trust receives a corresponding deduction for the income carried out to the beneficiary, subject to the applicable limits. (Note: Beginning in 2026, the new 2/37ths limitation under IRC § 68 raises a question about whether a trust in the top tax bracket must reduce its distribution deduction even though the beneficiary reports the distributed income. That issue is beyond the scope of this outline.)

DNI is a tax calculation, not the trust's bank balance or the amount labeled "income" in its accounting records. A payment from accounting principal can still carry out current taxable income to the beneficiary. If the payment exceeds DNI, the excess is not taxable to the beneficiary solely because it came from the trust.

The beneficiary does not have to receive cash for a payment to carry out DNI. When the trustee pays a caregiver, landlord, or other provider, or purchases an iPhone or clothes for the beneficiary's benefit, the payment can carry taxable income to the beneficiary. The trustee should distinguish these payments from the trust's own administration expenses, such as accounting or legal fees, and give the beneficiary's tax preparer the Schedule K-1 information needed for the individual return. If the trustee distributes property instead of cash, the trustee must also address the property's value, tax basis, and whether the transfer creates taxable gain.

For example, in 2026 a nongrantor third-party SNT that qualifies as a QDisT earns \$30,000 of taxable ordinary income. The trust pays \$20,000 for the beneficiary's caregiver and \$5,000 for the beneficiary's travel. The beneficiary receives a Schedule K-1 reporting \$25,000 of income. The trust retains \$5,000 of income, which is offset by the QDisT's \$5,300 exemption.

When a nongrantor third-party SNT sells an appreciated asset, the gain stays taxable to the trust if it is allocated to principal and is not treated as part of a distribution. The gain can instead be included in DNI when the trust terms, state law, and the trustee's administration support that treatment.

Coordinating Taxation with SSI and Medicaid

Tax reporting and benefits eligibility require separate analyses. A grantor trust can produce taxable income for its owner without a distribution, while a nongrantor trust can carry out DNI through a payment made directly to a vendor. Neither result, standing alone, determines the payment's treatment under SSI or Medicaid. The trustee should identify the beneficiary's actual programs and Medicaid eligibility category before advising on a distribution.

Since September 30, 2024, food is no longer counted as in-kind support and maintenance (ISM) for SSI, but shelter support can still affect the benefit. For example, rent paid directly to a landlord may carry out DNI from a nongrantor third-party SNT and, separately, create SSI shelter income. A direct payment for dental care, a laptop, or adaptive equipment may carry out DNI without becoming shelter income.