

Understanding Tax Treatment for SNTs

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Program Overview

- First-party SNTs: income, gift and estate tax treatment, basis adjustment, and Medicaid payback.
- Third-party SNTs: revocable and irrevocable trusts; income, gift and estate tax treatment.
- Qualified Disability Trusts (QDisTs): requirements and tax treatment.
- Nongrantor trusts: Distributable Net Income (DNI), distributions, and the 65-day rule.
- Practical tax considerations for trustees and attorneys.

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Tax Classification Matters

- Income tax treatment and estate tax treatment are separate. Grantor trust status does not determine whether the trust assets are included in the grantor's gross estate.
- Tax ownership determines who reports income, who receives deductions and credits, and whether distributions carry out DNI.
- Transfer tax classification affects completed gifts, estate inclusion, basis adjustment, and planning flexibility.
- Public benefit "income" is a separate concept from taxable income and trustees must understand the difference.

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SNTs: Start with the Source of Funds

SNT Type	Whose Assets?	Tax Starting Point
First-party / self-settled	Beneficiary	Usually grantor trust to beneficiary
Pooled Trust	Beneficiary	Usually grantor trust to beneficiary
Third-party revocable	Parent / other donor	Grantor trust to donor
Third-party irrevocable	Parent / other donor	Grantor or nongrantor/QDisT (depends on powers)
Testamentary third-party	Decedent	Nongrantor/QDisT

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One SNT: Four Analyses

Question	Income Tax	Gift Tax	Estate Tax	Benefits
Who owns the trust's income?	Grantor, Trust or Beneficiary	N/A	N/A	N/A
Was trust funding a transfer?	N/A	Complete or incomplete gift	May affect inclusion	Must not create countable resource
What happens at beneficiary's death?	Final 1041 / K-1	N/A	Gross estate / basis	Payback / remainder rules
What does a distribution do?	DNI / K-1	Usually no new gift by trustee	N/A	SSI/Medicaid consequences

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First-Party SNTs: Legal Structure

- Funded with assets belonging to the individual with a disability.
- A (d)(4)(A) trust, beneficiary must be under age 65 when established and funded.
- Trust is irrevocable and for the beneficiary's sole benefit during life.
- At death, state Medicaid agencies are reimbursed before remainder distributions.
- Common funding: personal injury recoveries, inherited assets received outright, retroactive benefits, child support.

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First-Party SNTs: Grantor Trusts

- Grantor trust status is determined under IRC §§ 671–679 based on retained interests and powers, not by the trust's classification as a first-party SNT under the Medicaid rules.
- The beneficiary is treated as the grantor because the trust is funded with the beneficiary's own property and receives the benefit.
- Because trust income and principal remain available for the beneficiary's benefit, first-party SNTs generally are treated as grantor trusts under IRC § 677.
- As a result trust items of income, deduction and credit are reportable by the beneficiary as though earned or incurred directly by the beneficiary.

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First-Party SNTs: Why Grantor Trust Status Matters

- Beneficiary is responsible for income tax attributable to the trust's income.
- Beneficiary is taxed on the trust's income whether or not the income is distributed to beneficiary.
- This is advantageous because individual income tax brackets are less compressed than the brackets applicable to trusts.
- Income tax and public benefits rules are separate: income taxable to the beneficiary does not necessarily constitute income to the beneficiary for SSI or Medicaid purposes.

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First-Party SNTs: Income Tax Reporting

- Trust's items of income, deduction and credit are reported on beneficiary's individual income tax return.
- Trustee may file Form 1041 with a grantor trust information statement.
- Trustee must coordinate with beneficiary and provide necessary information (and at times assist with return).
- Trustee can pay beneficiary's income tax liability attributable to trust income.
- Grantor trust reporting and DNI distribution reporting are different regimes – beneficiary should not receive K-1 for income attributable to the beneficiary under the grantor trust rules.

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First-Party SNTs: Gift Tax Considerations

- Funding a first-party SNT with the beneficiary's own assets does not constitute a completed gift merely because the assets are transferred to the trust.
- The beneficiary is the sole lifetime beneficiary, and the trust assets remain available for the beneficiary's benefit.
- This is true even though the beneficiary cannot compel distributions and distributions are made in the trustee's sole discretion.
- Gift tax treatment depends on the beneficiary's retained interests and the terms governing disposition of the trust at death.

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First-Party SNTs: Estate Inclusion

- First-party SNT assets are generally included in beneficiary's gross estate for federal estate tax purposes.
- Beneficiary funded trust with their own assets and retains beneficial interest during lifetime.
- Estate inclusion does not mean estate tax will be due.
- Estate tax liability depends on the value of beneficiary's taxable estate after allowable deductions and the applicable estate tax exemption.
- Medicaid payback is an allowable deduction under IRC § 2053.

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First-Party SNTs: Basis Adjustment at Death

- When SNT assets are included in the beneficiary's gross estate, qualifying assets receive a basis adjustment to fair market value at death under IRC § 1014.
- For appreciated assets, the basis adjustment can reduce or eliminate capital gain when the assets are sold.
- Trustee should obtain and retain date-of-death values for trust assets, even if no estate tax return is required.
- Certain assets, such as retirement accounts are exceptions to the general basis adjustment rule.

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First-Party SNTs: Estate Inclusion Example

- First-party SNT value at beneficiary's death: \$17 million
- Assumed federal estate tax exemption: \$15 million
- Medicaid payback obligation: \$5 million
- The \$17 million SNT is included in the beneficiary's gross estate.
- Medicaid payback is deductible under IRC § 2053.
- After the \$5 million deduction, the amount attributable to the SNT for purposes of this taxable estate calculation is \$12 million.
- \$12 million is less than \$15 million estate tax exemption, no federal estate tax is due.
- No federal estate tax is due, but Form 706 is still required because the \$17 million gross estate exceeds the \$15 million filing threshold.
- Consider state estate tax obligations.

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First-Party SNTs: Trustee Tax Checklist

- Determine grantor trust reporting method and coordinate with the beneficiary's tax preparer.
- Provide the beneficiary with the information needed to report trust income, deductions and credits.
- Plan for payment of income taxes attributable to trust income.
- Maintain tax basis records for trust investments.
- At death, obtain date-of-death values for all trust assets.
- Determine Medicaid payback before final distributions.
- Determine whether a federal and/or state estate tax returns are required.
- Coordinate income tax, estate tax and final trust administration before distributing the remainder.

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Third-Party SNTs: Legal Structure

- Beneficiary never owned the contributed assets; common funding is parent estate planning.
- No Medicaid payback requirement.
- Lifetime trust may be revocable or irrevocable; testamentary trust is created at death.
- Tax treatment depends on structure:
 - Income tax owner may be the donor, the trust, or sometimes another person under the grantor-trust rules.
 - Transfer tax results depend on retained powers, beneficiary rights, and powers of appointment.

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Revocable Third-Party SNTs

- Grantor retains the power to revoke; grantor is the income tax owner under IRC § 676.
- Funding is an incomplete gift because the grantor can revoke the trust and take the trust assets back.
- Trust assets are includable in the grantor's estate under IRC § 2038.
- At grantor's death, trust becomes irrevocable and tax classification must be reassessed.
- Basis adjustment at grantor's death under IRC § 1014.

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Irrevocable Third-Party SNTs: Gift Tax

Completed Gift

- Donor has given up control over the transferred property.
- Donor cannot take the property back or change who will benefit from it.
- The transfer is treated as a gift when made and uses the donor's annual exclusion (with CAUTION) and/or lifetime gift tax exemption.

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Irrevocable Third-Party SNTs: Gift Tax

Incomplete Gift

- Donor retains enough control over the property or who will ultimately receive it so that the gift is not yet complete.
- The property is also included in the donor's estate at death.
- The gift can become complete later if the donor gives up or loses that retained power.

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Irrevocable Third-Party SNTs: Annual Exclusion & Crummey Powers

- The gift tax annual exclusion applies only to a gift of a present interest.
- A gift to an SNT is a gift of a future interest because the beneficiary cannot demand immediate distribution of the contributed property.
- In irrevocable trust planning, Crummey withdrawal powers are often used to give beneficiaries a temporary right to withdraw a contribution, creating a present interest that may qualify for the annual exclusion.
- Crummey powers are typically not granted to an SNT beneficiary receiving means-tested benefits because the beneficiary has a present right to access the contributed funds.
- As a result, contributions to an SNT often do not qualify for the annual exclusion and instead use a portion of the donor's lifetime gift and estate tax exemption.

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Example: Gift to Irrev. Third-Party SNT

Facts

- Parent contributes \$500,000 to an irrevocable third-party SNT for an adult child receiving SSI and Medicaid.
- Parent retains no right to revoke the trust or recover the property.
- Independent trustee has sole discretion over distributions.
- Beneficiary has no Crummey withdrawal power.

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Example: Gift to Irrev. Third-Party SNT

Gift Tax Result

- Parent has made a completed gift of \$500,000 to the trust.
- Because the beneficiary does not have a present interest in the contribution, assume the annual exclusion is unavailable.
- Parent reports the \$500,000 gift on Form 709.
- The gift uses \$500,000 of the parent's available lifetime gift and estate tax exemption.
- No current gift tax is due if the parent has sufficient exemption remaining.

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Irrevocable Third-Party SNTs: Estate Tax Treatment

- A completed gift to an irrevocable third-party SNT removes the transferred assets from the donor's gross estate.
- Future appreciation on those assets is also outside the donor's estate.
- The donor must not retain interests or powers that would cause the trust assets to be included in the donor's gross estate.
- If the trust assets are not included in the donor's gross estate, they do not receive a basis adjustment at the donor's death under IRC § 1014.
- Removing future appreciation from the donor's estate can be an important estate planning benefit for a donor with a taxable estate.
- Grantor trust status for income tax purposes does not, by itself, cause estate inclusion.

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Irrevocable Third-Party SNTs: What Happens When the Beneficiary Dies?

- Third-party SNT assets are not included in the beneficiary's estate simply because the beneficiary received discretionary benefits from the trust.
- The beneficiary never owned the trust assets.
- However, estate inclusion can result if the beneficiary holds certain powers over the trust, particularly a general power of appointment under IRC § 2041.
- A limited or special power of appointment granted to the beneficiary can provide flexibility without causing estate inclusion if properly drafted.
- Any assets remaining at the beneficiary's death pass to the remainder beneficiaries without a Medicaid payback requirement.

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Irrevocable Third-Party SNT – Income Tax

- An irrevocable third-party SNT can be structured as a grantor trust for income tax purposes.
- A common grantor trust trigger is the grantor's retained power to substitute assets of equivalent value under IRC § 675(4)(C).
- The grantor reports the trust's income, deductions and credits on the grantor's individual income tax return.
- The grantor's payment of the income tax allows the trust assets to grow without reduction for income taxes.
- The substitution power creates grantor trust status without causing the trust assets to be included in the grantor's gross estate.

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What is a Qualified Disability Trust (QDisT)?

- A QDisT is a nongrantor trust that meets the requirements of IRC § 642(b)(2)(C).
- It is a tax classification, not a separate type of special needs trust.
- A QDisT receives a larger personal exemption than an ordinary complex trust.
- A grantor trust cannot also be treated as a QDisT.

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QDisT Requirements

- The trust must be:
 - Irrevocable;
 - established solely for the benefit of an individual under age 65 who meets the Social Security definition of disability; and
 - a nongrantor trust for income tax purposes.

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QDisT: What Does Sole Benefit Mean?

- During the beneficiary's lifetime, the trust must be solely for the beneficiary's benefit.
- The trust should not permit distributions to other beneficiaries during that time.
- Other individuals or charities can be named to receive the trust assets after the beneficiary dies.
- Normal trust expenses, including trustee fees and administrative expenses, do not violate the sole benefit requirement.

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QDisT Exemption 2026

- A QDisT receives a **\$5,300 personal exemption for 2026**.
- By comparison, an ordinary complex trust receives only a **\$100 exemption**.
- The exemption reduces the trust's taxable income.
- It does not change the trust from a nongrantor trust to a grantor trust.
- The exemption amount is adjusted for inflation.

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QDisT Example

Facts

- Third-party SNT qualifies as a QDisT.
- Trust has **\$20,000 of taxable ordinary income**.
- Trustee makes **no distributions** during the year.
- Assume no other deductions.

Tax Result

- Taxable income before exemption: **\$20,000**
- Less QDisT exemption: **\$5,300**
- Trust taxable income: **\$14,700**

Compare to Complex Trust:

- \$20,000 income
- Less \$100 exemption
- Taxable income: **\$19,900**

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Nongrantor Trusts: DNI

- Nongrantor trusts reach the highest federal income tax rate at low levels of taxable income.
- For 2026, the 37% bracket begins when taxable income exceeds \$16,000.
- When the trustee makes a distribution, the trust receives a deduction and the beneficiary has taxable income.
- Distributable net income (DNI) determines how much taxable income passes from the trust to the beneficiary.
- A payment made directly to a third-party vendor for the beneficiary's benefit can also be treated as a distribution and carry out DNI, even though the beneficiary never receives the cash.

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Nongrantor Trusts: DNI

- The beneficiary is typically in a lower tax bracket.
- The beneficiary receives a Schedule K-1 reporting the taxable income carried out by the distribution.
- A distribution should not be made just to save taxes. The trustee must also consider the trust terms, beneficiary's needs, and effect on public benefits.
- Trustees should review income and anticipated distributions before yearend, while there is still time to plan.

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Nongrantor Trusts: DNI Example

Assume:

- SNT has \$20,000 of ordinary income, all of which is included in DNI.
- Trustee distributes \$10,000 for the beneficiary during the year.
- No other deductions.
- Beneficiary is in a lower income tax bracket than the trust.

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Nongrantor Trusts: DNI Example

	QDisT	Ordinary Complex Trust
Trust income	\$20,000	\$20,000
Distribution/DNI deduction	(\$10,000)	(\$10,000)
Exemption	(\$5,300)	(\$100)
Trust taxable income	\$4,700	\$9,900
K-1 to beneficiary	\$10,000	\$10,000

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The 65 Day Rule: A Year-End Planning Tool

- IRC § 663(b) allows a trustee to treat certain distributions made during the first 65 days of a new tax year as if they were made in the prior tax year.
- Gives trustee additional time after yearend to determine the trust's income and DNI for the prior year.
- The distribution can then carry out prior-year DNI to the beneficiary and reduce the income taxed to the trust.
- The beneficiary reports the distribution for the prior tax year, even though the payment was actually made in the following year.
- The election is made on the trust's Form 1041 and applies only to the amount that qualifies under the 65 day rule.

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SNTs Generally: A Primer on Income

What is Income?

- Benefits income is not the same as taxable income.
- This concept is often confused by Social Security and Medicaid workers; we often need to educate them about their own rules.

Taxable Income

- For purposes of trusts and taxable income, distribution of income is either distribution directly to or for the benefit of the beneficiary.

Benefits Income

- For purposes of "needs based" benefits, income is cash, or anything that can be used for shelter unless it is exempt.

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SNTs – Income Example

Benefits Income ≠ Taxable Income

- If the trustee of a SNT pays the beneficiary's telephone bill directly from the trust, the beneficiary has received a benefit and therefore has received taxable income to the extent it is made up of DNI.
- In this example, the beneficiary did not receive any income for benefits purposes because the beneficiary did not receive cash or shelter.

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SNTs – Income Example

Benefits Income ≠ Taxable Income

- If the trustee of a SNT pays the beneficiary's rent directly from the trust and the beneficiary receives SSI, the beneficiary has received a benefit and therefore has received taxable income to the extent it is made up of DNI.
- In this example, the beneficiary will lose 1/3 of her SSI benefit as the payment of shelter is considered income to the beneficiary.

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Trustee Annual Tax Checklist

- Confirm whether the trust is a grantor trust, nongrantor trust, or QDisT.
- Make sure all tax reporting documents, including 1099s, are provided to the accountant.
- Before yearend, review anticipated distributions and how much DNI may be carried out to the beneficiary.
- Make sure there is enough cash available to pay taxes and other trust expenses.
- Consider the SSI and Medicaid impact before making distributions.
- Determine whether the trust has income tax filing obligations in multiple states.

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Attorney Tax Drafting Checklist

- Determine at the outset whether the trust is intended to be a grantor or nongrantor trust.
- Review the powers retained by the grantor and how they affect income, gift, and estate tax treatment.
- Be careful with withdrawal rights and powers of appointment that could create tax or public benefits problems.
- If QDisT treatment is intended, make sure the trust meets the requirements for QDisT status.
- Consider the tax consequences before amending, decanting, or otherwise modifying the trust.
- Make sure the drafting is consistent with the intended tax treatment.

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Common Tax Mistakes with SNTs

- Assuming all SNTs are taxed the same way.
- Assuming every irrevocable SNT is a nongrantor trust.
- Assuming every nongrantor SNT qualifies as a QDisT.
- Using Crummey withdrawal powers without considering the impact on the beneficiary's SSI or Medicaid.
- Failing to plan for the income tax owed on trust income.

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Final Takeaways

- First-party SNTs are usually grantor trusts, with the beneficiary responsible for the income tax.
- Third-party SNTs can have very different income, gift, and estate tax consequences depending on how the trust is structured.
- An irrevocable third-party SNT can be a grantor or nongrantor trust.
- A QDisT is a special tax classification available to certain nongrantor trusts; it is not a separate type of SNT.
- For nongrantor trusts, distributions and DNI determine how taxable income is divided between the trust and the beneficiary.
- Tax planning should never be done without also considering the beneficiary's SSI, Medicaid, and other public benefits.

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Thank you!

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