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GUIDEPOST

# Special Needs Trust

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An important component of planning for individuals with special needs is to ensure the individual qualifies for available government benefits since such benefits are often critical in providing for the individual's ongoing support. Though maintaining eligibility for government benefits is often important, many caregivers and family members also wish to augment what is provided through government benefit programs. However, because many government benefit programs are "needs-based," it is important to ensure that any assets made available to support an individual with special needs will not be "countable" for the purposes of determining eligibility for government benefits. Needs-based government benefit programs generally provide that ownership of assets in excess of certain values or receipt of income in excess of certain amounts disqualifies an individual from the program.

Utilizing a special needs trust (SNT) allows assets to be held for the benefit of an individual with special needs in a manner that will not disqualify him/her from needs-based government benefit programs. A SNT (sometimes referred to as a "supplemental needs trust") is a specific type of trust created to hold property for an individual with special needs. Since most government benefit programs are run at the state or local level, it is important to determine specifically which programs the individual with special needs may qualify for and draft the trust in a manner that ensures trust assets do not impact his/her eligibility for such benefits.

## First-party SNT

A first-party SNT is a trust for the benefit of an individual with special needs that is funded with his/her assets. These trusts are often referred to as "Medicaid Payback Trusts" or "(d)(4)(A) Trusts" (after the section of the United States Code [USC] allowing for such trusts). Where an individual with special needs owns assets in excess of the allowable limit for needs-based government benefits, funding a first-party SNT with the individual's assets often allows him/her to reduce his/her countable assets to a level that qualifies for certain government programs. Generally, a transfer of assets to another individual or to a trust will create a "look-back" period regarding eligibility for needs-based government benefits. However, 42 USC §1396p(d)(4)(A), as amended by the Omnibus Budget Reconciliation Act of 1993, created a first-party SNT exception so that transfers of assets owned by the individual with special needs to the trust will not trigger a look-back period.

To qualify as a first-party SNT, 42 USC §1396p(d)(4)(A) provides that the following requirements must be met:

- The trust must be irrevocable;
- The trust must be for the sole benefit of a "disabled" individual, as defined by 42 USC §1396p(d)(4)(A);
- The disabled beneficiary must be under age 65;
- The trust must be funded with the disabled beneficiary's assets;
- The trust must be created by a parent, grandparent, or guardian of the disabled beneficiary or created by the court (however, the SNT Fairness Act allows an individual with special needs to create their own trust if they are mentally competent); and
- The trust must include Medicaid payback provisions requiring that any Medicaid benefits provided to the trust beneficiary will be repaid with trust assets upon the death of the beneficiary or the trust's termination (each state has its own rules regarding the calculation of the payback amount).

If a trust qualifies as a first-party SNT, trust assets will be available to provide supplemental support to the trust beneficiary in a manner that does not impact his/her eligibility for needs-based government benefits. Upon the beneficiary's death, any assets that remain in the trust after satisfying the Medicaid payback requirement can pass to residuary beneficiaries as named in the trust. Often, first-party SNTs are funded with assets the individual with special needs accumulated through his/her employment, inheritances and/or personal injury settlements.

## First-party pooled SNT

A pooled trust is a specific type of first-party SNT created by 42 USC §1396p(d)(4)(C). Unlike other first-party SNTs, a pooled trust is managed and operated by a non-profit organization. Each beneficiary of a pooled trust has his/her own sub-account within the trust, but trust assets are pooled for investment and management purposes. To qualify as a first-party pooled SNT, 42 USC §1396p(d)(4)(C) provides that the following requirements must be met:

- The sub-account must be for the sole benefit of a disabled individual;
- The sub-account must be created by the disabled individual's parent, grandparent, legal guardian, court or by the disabled individual if he/she has mental capacity;
- Unlike other first-party SNTs, there is no age requirement so that a trust can be established for a disabled individual over age 65; and
- At the disabled individual's death, remaining assets generally remain in trust for other beneficiaries of the pooled trust instead of being used to repay Medicaid.

First-party pooled SNTs are generally less costly to create and easier to administer since the trust is created through a master agreement as established by the non-profit organization and administered by the non-profit organization.

## Tax considerations

Generally, a first-party SNT is a "grantor" trust with respect to the beneficiary with special needs so that the income, deductions, and credits of the trust flow through to the beneficiary and will be reported on his/her personal tax return. (Though it is not a requirement that first-party SNTs are drafted as grantor trusts, practically, the grantor/beneficiary's ability to benefit from trust assets usually results in grantor trust status.) To the extent the beneficiary has little to no income, grantor trust status can prove beneficial since the beneficiary's tax bracket will likely be lower than the trust's tax bracket.

Additionally, since the beneficiary's assets are used to fund a first-party SNT and since trust assets can be distributed for his/her benefit, transfers to first-party SNTs are generally not completed gifts for gift tax purposes (so no gift tax liability will result). Trust assets are generally included in the beneficiary's taxable estate.

## Third-party SNT

A third-party SNT is a trust for the benefit of an individual with special needs (the beneficiary) that is funded with assets owned by anyone other than the beneficiary. Third-party SNTs allow for caregivers and family members of an individual with special needs to provide for his/her needs not otherwise being provided for through government benefit programs.

Since assets used to fund the trust are never a "countable" resource of the individual with special needs, third-party SNTs are generally more flexible than first-party SNTs. A third-party SNT can be created during the lifetime of the individual creating the trust (the grantor) as an irrevocable trust or a revocable trust, or, at the grantor's death via a testamentary trust created in a will/revocable living trust. Creating a third-party SNT during the grantor's lifetime provides other family members and caregivers with a vehicle to facilitate gifts or bequests for the beneficiary, reducing the risk that assets are inadvertently transferred to the beneficiary outright, thus jeopardizing his/her access to government benefits. Creating an irrevocable trust during the grantor's lifetime also provides the grantor a mechanism to help support the beneficiary in an estate tax efficient manner (since assets transferred to the trust are generally removed from the grantor's taxable estate).

To ensure the assets of a third-party SNT are not counted as a resource of the trust beneficiary, the following should be considered:

- The beneficiary with special needs should not have any power to revoke the trust, direct the use of trust assets, or otherwise control trust assets.
- The provisions of the trust should ensure that trust assets are only used to supplement the care and support of the beneficiary with special needs in a manner not otherwise provided for through government benefits. (In fact, many

trusts include language specifically defining the grantor's intent that trust assets not disqualify the beneficiary from government benefits and that assets are to be used to "supplement and not supplant" such benefits.)

- The trustee should have discretion to distribute assets for the beneficiary, as opposed to basing distributions on an ascertainable standard (such as health, education, maintenance, and support).
- Since distributions from the trust to a beneficiary with special needs could impact his/her eligibility for government benefits, the trust instead should allow the trustee to use trust assets for the beneficiary (i.e., paying expenses, purchasing assets for the beneficiary's use, etc.).
- The trust should provide that the beneficiary with special needs has no right to assign his/her right to future payments or distributions from the trust.
- The trustee should be given broad investment powers so he/she can use trust assets in a manner to best provide for the beneficiary.
- The beneficiary with special needs should be prohibited from serving as trustee or from removing and replacing the trustee (or trust protector).
- To plan for changes to tax law or eligibility for government benefits (or if a beneficiary moves to a different state with different eligibility requirements), it may be prudent to give a third-party trust protector the right to amend the trust to ensure the grantor's intent is satisfied.

Upon the death of the beneficiary with special needs, remaining assets of a third-party SNT are not subject to any reimbursement claims by the government since these assets were never part of the beneficiary's estate. If there is a first-party SNT and a third-party SNT, the third-party SNT should allow for distributions only where the first-party SNT is unable to make distributions, since spending down the first-party SNT may prove more efficient as a result of its Medicaid payback requirement.

### **Tax considerations - Revocable third-party SNT**

A revocable third-party SNT will be treated as a grantor trust to the grantor and all items of trust income, credits, and deductions flow through to the grantor.

Transfers to a revocable third-party SNT will not be a completed gift for gift tax purposes since the grantor can revoke the trust and retain possession of trust assets. Revocable third-party SNT assets will be included in the grantor's taxable estate.

### **Tax considerations - Irrevocable third-party SNT**

An irrevocable third-party SNT can be drafted as a non-grantor or grantor trust. If drafted as a non-grantor trust, the trust can be taxed as a complex trust or a qualified disability trust.

Complex trust rules typically apply where trust income is not mandatorily distributed to the beneficiary. Since mandatory distributions of income would likely impact a beneficiary's access to government benefits, a properly drafted SNT will usually be a complex trust. With a complex trust, generally, income retained in the trust is taxed to the trust at trust rates and income distributed to a beneficiary (or for his/her benefit) is taxed to the beneficiary at his/her personal rates.

A qualified disability trust enables the trust to receive an exemption equal to the personal exemption when computing income tax liability. To qualify, the trust must be for the sole benefit of a disabled beneficiary (pursuant to Social Security's definition of disability) and the trust must be funded prior to the disabled beneficiary's age of 65. Though the Tax Cuts and Jobs Act of 2017 effectively eliminated personal exemptions, it does retain personal exemptions for qualified disability trusts and sets the exemption at \$4,150, adjusted for inflation (\$5,000 in 2024).

If an irrevocable third-party trust is drafted as a grantor trust, all items of trust income, credits, and deductions flow through to the grantor.

Since gifts to an irrevocable third-party SNT are generally completed gifts, such gifts are taxable. The basic exclusion amount (\$13.61 million in 2024) can be used to make tax-free gifts to the trust during the donor's lifetime. Alternatively, where

beneficiaries other than the individual with special needs are named, giving the beneficiaries (other than the beneficiary with special needs) a “Crummey” withdrawal right can allow for tax-free gifts to the trust if they qualify for the annual gift tax exclusion amount (\$18,000 per beneficiary in 2024). The individual with special needs should not be named as a Crummey withdrawal beneficiary since he/she should have no power to control or direct trust assets.

If properly drafted and funded, assets of an irrevocable third-party SNT should not be included in the grantor’s estate for estate tax purposes.

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