

II. Third-Party Supplemental Needs Trusts – Trusts funded with the assets of someone other than the trust’s primary beneficiary (typically, an individual with special needs who may be eligible for Medicaid and other governmental entitlements).

A. Inter Vivos or Testamentary

1. Inter Vivos

a. Grantor Trust – The settlor must decide whether an inter vivos third-party supplemental needs trust should be a grantor trust (which can be either a revocable trust or an irrevocable trust) or a non-grantor trust (which must be an irrevocable trust) as to the settlor during the settlor’s lifetime.

(i) A **revocable** third-party supplemental needs trust will be a grantor trust as to the settlor (see IRC § 676), will not qualify as a taxable gift for gift tax purposes (see IRC § 2511; still available to settlor’s creditors and still within the settlors “dominion and control”), and will be included in the settlor’s gross estate for estate tax purposes upon the settlor’s death (see §§ IRC Sec. 2036 and 2038) with qualifying assets receiving a stepped-up basis at that time (see § IRC Sec. 1014).

(ii) An **irrevocable** trust can be structured so that it is either a grantor trust, a non-grantor trust, or both.

i. There is a transfer tax planning benefit if the settlor is responsible for paying income taxes generated by trust assets if the initial transfer constitutes a completed gift for gift tax purposes (i.e., more wealth can be pushed through transfer tax free when the settlor is responsible for paying income tax on trust’s income if there is a completed gift upon transfer to the trust and the trust property will not be included in the settlor’s gross estate upon death). See Revenue Ruling 2004-64 (no gift to trust beneficiary or beneficiaries for gift tax purposes if settlor pays income tax on income from trust assets due to grantor trust status).

ii. Although it would be quite desirable for income tax purposes, it is not recommended to create grantor trust status as to the primary beneficiary due to probable loss and/or ineligibility of Medicaid and other public benefits. See IRC § 678.

b. Non-Grantor Trust – To be an inter vivos non-grantor trust, the third-party supplemental needs trust must be irrevocable.

(i) Does the settlor want to be responsible for reporting income and paying income tax on money that is no longer for the settlor’s benefit? Can the settlor afford to pay income tax on income if the settlor has no legal access to the trust assets? But, see Revenue Ruling 2004-64 (the trust can contain a provision for the trust to pay the settlor’s income tax liability attributable to trust’s income without causing estate tax inclusion in the settlor’s gross estate; this would be best structured if an independent and nonadverse trustee has discretion to make such distributions to the settlor).