Special needs trusts and annuities

How an annuity can be a powerful funding vehicle inside a special needs trust

Many safeguards are in place to protect our most vulnerable citizens, including financial care for disabled individuals. Social Security, Supplemental Security Income, Medicaid, and state-specific programs are available for those who are unable to work or care for themselves because of a disability.

To qualify for these programs, an individual must meet strict—and very low—income and asset levels. For Medicaid, the limits vary state to state, but in general if an individual is within 133% of the federal poverty level, they can qualify for it. In 2023, the federal poverty level is $14,580 for a single-person household.[1] If an individual earns more than this, they may not qualify for all Medicaid benefits.

Benefits of a special needs trust

In addition to individual governmental assistance, a disabled person's loved ones may also set up a special needs or supplemental needs trust. It provides additional assets on an as-needed basis to supplement an individual's needs or lifestyle. For example, if the individual needs expensive medical equipment, it can be purchased with the assets in the trust. Creating a trust is generally better than directly gifting or bequeathing money to disabled individuals, which may increase their income and asset levels and disqualify them from governmental benefits—an outcome that should be avoided.

A special needs trust is a type of irrevocable trust. A trustee, usually a family member, is named to administer the trust assets. The terms of the trust are usually conspicuously worded to state that the assets are to be used only for the benefit of the disabled individual. The trustee may be given discretion to use those assets in the manner the trustee sees fit. Since these funds are available on an as-needed basis, there will be some years when no withdrawals are taken and other years when large ones are taken.

Drawback

As an irrevocable trust, a special needs trust is considered its own separate taxable entity with its own tax identification number. It's subject to compressed trust tax rates. Investment earnings in excess of $14,450 will trigger the highest federal marginal tax rate of 37%, plus any applicable state income tax and the 3.8% net investment income tax must also be taken into account.[2] In high-tax states like California, New York, or Minnesota, earnings in excess of $14,450 inside a special needs trust could be taxed at nearly a 50% marginal rate.

[1] United States Department of Health and Human Services, Annual Update of HHS Poverty Guidelines, January 19, 2023.

[2] Rev. Proc. 2022-38, Table 5 - Section 1(j)(2)(E).

Trustee goals

The two main goals of a special needs trustee are preservation of capital for the individual's needs and limiting tax drag. Both can be accomplished by utilizing an annuity inside of the special needs trust.

Annuity titling:

Owner	Annuitant	Beneficiary
Special needs trust	Special needs individual	Special needs trust

This titling is the most efficient way to use an annuity inside a special needs trust. By making the individual the annuitant (i.e., the measuring life of the contract), the annuity contract will terminate on the death of that individual. The trust is also drafted to terminate at that time. Any amount left in the annuity and trust will be paid out to a remainder beneficiary named in the trust, generally a sibling or other family member. Only self-settled trusts (i.e., those funded by the special needs beneficiary) require the state to be named as the primary remainder beneficiary.

Tax benefits of a special needs trust annuity

The driving force of an annuity in a special needs trust is the tax benefits. These benefits are twofold:

1. All assets in a special needs trust are nonqualified and subject to annual taxation on any investment gains. Finding a tax-efficient vehicle is critical to avoiding potentially ruinous tax drag. An annuity can provide the tax efficiency trustees need. A fixed or fixed index annuity can provide capital preservation without risk of loss and upside potential to help ensure those assets are there to benefit the disabled individual. A variable annuity can provide tax efficiency within a well-diversified portfolio, which has the potential to keep up with or exceed inflation.

2. Typically when money is withdrawn from an annuity and paid to an individual younger than age 59½, there is a 10% tax penalty on any earnings. However, if the individual meets the Social Security definition of disabled, which they will when receiving Supplemental Security Income (SSI), the 10% penalty is waived. The ability to enjoy the tax efficiency of an annuity wrapper and the avoidance of the 10% tax penalty can be beneficial for the special needs trust.

Case study

Consider this typical scenario for a special needs trust.

John and Suzanne, both age 85, care for their disabled son, Alec, age 50, who lives with them and receives SSI and Medicaid benefits. They also pay for any of his needs that aren't covered by government programs. They have $500,000 in nonqualified assets, which Alec will inherit when they pass away.

If John and Suzanne name their son as the beneficiary, the $500,000 will disqualify him from future SSI and Medicaid benefits. Additionally, Alec is incapable of competently managing these assets. He would be on his own for basic needs: finding new living arrangements, grocery shopping, purchasing clothing, etc.

Instead, John and Suzanne name a special needs trust to benefit their son. At their death, the $500,000 passes to the trust. It will not be counted for SSI and Medicaid purposes, so Alec will not be disqualified from any government benefits. The trust names Alec's cousin Abby as the trustee and gives her discretion to use the funds as needed. The combination of government benefits and supplemental assets from the trust will allow her to pay for Alec's continued care and new living arrangements in a facility capable of meeting his needs.

If the $500,000 were invested in a taxable account, it would take less than a 3% return to trigger the highest marginal trust tax rates. Abby, acting as trustee, invests the $500,000 into an annuity contract for tax efficiency. As a fiduciary, she eliminated tax drag inside the trust and knows the assets can be accessed at any time in the next nine years without triggering the 10% tax penalty for withdrawals before age 59½. Keep in mind, some annuity contracts may enforce a surrender penalty on amounts withdrawn in excess of certain limitations. Overall, this is a better outcome for the family.

Consult an expert

Planning for a disabled family member is a complicated process. Consulting with a qualified financial professional or estate planning attorney is a necessity.

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