Basics of Special Needs Trusts

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Breakout Session 2
2:30 P.M. – 3:30 P.M.

Differences Matter – First vs. Third Party SNTs: Structure and Creation

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- Materials
- PowerPoint

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1. Introduction

The purpose of any special needs trust is to maximize resources for an individual with disabilities. Many individuals with disabilities rely on means-tested (or needs-based) public benefits that have income and/or asset limits. The two most common types are Supplemental Security Income (SSI) and Medicaid. It would be prohibitively expensive for many individuals to replace these public benefits and services by privately purchasing them. And this same network of support is sometimes simply unavailable except through these public benefit programs. If an individual who has means-tested public benefits later receives and retains income and/or assets in excess of the eligibility limits for a particular public benefits program, he or she will forfeit eligibility for these important benefits.

A special needs trust is designed to receive and administer assets for the benefit of the individual with a disability. If the trust is drafted, established, and administered correctly, the transfer of assets into the trust and the existence of the trust assets will not disqualify the trust beneficiary from means-tested public benefits. The beneficiary continues to receive the public benefit and, at the discretion of the trustee, has access to the trust assets that improve the quality of the beneficiary’s life.

A common phrase used to describe special needs trusts is that they “supplement, not supplant” public benefits. As a result, special needs trusts are sometimes referred to as supplemental needs trusts. For the purpose of this article (and among elder law attorneys, in general), the terms are interchangeable. The terms can refer to either first party trusts, which hold assets that belonged

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1 Lawyers who draft special needs trusts and the trustees who administer them must study and understand the public benefits available to individuals with disabilities. Some of them are means-tested and some are not. Social Security Disability Income (SSDI) is an insurance program based on an individual’s disability status and work history. It goes hand-in-hand with Medicare which is available to those who have received SSDI for 24 months. SSDI and Medicare are not means-tested, and therefore a special needs trust may be of little use for individuals with only those benefits. But an individual covered by SSDI and Medicare may also be eligible for SSI and Medicaid as well as a myriad of other means-tested public benefits that provide medical care, food, housing, and cash to individuals with disabilities. Each year, the Stetson University’s Special Needs Trusts – The National Conference provides excellent resources addressing and describing the “alphabet soup” of public benefits. The reader is encouraged to refer to those and keep abreast of changes to them.
to the individual with disabilities or to which he or she was legally entitled, or third party trusts, which hold assets that belonged to someone other than the individual with disabilities. A special needs trust is never a pure support trust which directs and requires the trustee to distribute to the beneficiary as much income and principal as is necessary for the beneficiary’s health, education, maintenance, and support. (But it may be a conversion from a support trust. See Section 2(C), below.) Instead, the trustee will have the sole discretion to make distributions from the trust.

This article will also touch on pooled special needs trusts which can be either first or third party trusts. It will also discuss the sole benefit trust which can be described as a hybrid of first party and third party special needs trusts.

This article is intended to be introductory overview to the purposes and basic differences between first party special needs trusts and third party special needs trusts.  

2. Preliminary Questions: Is a Special Needs Trust Necessary and Appropriate? Are There Alternatives?

A special needs trust is not always necessary when an individual with a disability is to receive or has received assets that, if kept, would disqualify him or her for means-tested public benefits. There may be other appropriate tools to protect those benefits or it may be appropriate to forego the benefits for a period of time. This article will not review the alternatives in depth, but lawyers asked about special needs trusts must consider them. In fact, it may be malpractice to fail to do so.

ABLE Act accounts will be available soon for special needs planning. In December 2014, Congress passed the Achieving a Better Life Experience Act (ABLE Act). The ABLE Act allows states to set up programs that permit individuals with disabilities or their family members to make contributions to 529A accounts which are similar to 529 education accounts. But there are some limitations on these accounts: they are only available to individuals whose disability was established before age 26; there can be only one ABLE Act account for an individual; anyone can contribute to the account, including

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2 This section provides a mere outline of the considerations for drafting a d4A trust. For a comprehensive review of statutory and equally important non-statutory drafting considerations, the reader is encouraged to consult the most recent edition of the Special Needs Trusts Handbook by Thomas D. Begley Jr. and Angela E. Canellos. The authors include valuable drafting tips, particularly in response to changes in the SSA’s Program Operations Manual System.
the individual, but total contributions in a year may not exceed $14,000 in a single year; funds can be used for “qualified disability expenses” and distributions for any other purpose will make the entire account countable as a resource; and upon the death of the account participant, the remaining account balance is subject to payback. However, an ABLE Act account may be a better choice in the case of a small inheritance, other unplanned receipt of modest funds, or a situation where the individual saves money and does not spend down the public benefits to remain below the income limit. An ABLE Act account may also be a good option if the family would like the individual to have more autonomy over a portion of assets while the rest are managed in a traditional special needs trust.

- With the passage of the Affordable Care Act in 2010, medical insurance companies are prohibited from denying coverage to individuals with pre-existing medical conditions. This means that a lawyer must consider whether purchasing a health insurance plan through the exchange or a Medicaid expansion program is a better choice than establishing and administering a special needs trust to maintain Medicaid eligibility.
- In some cases, individuals receive a modest enough sum that they can spend down the excess resources. Common spend down opportunities include purchasing a home or home improvements and repairs; furniture; books and education, including tuition; entertainment, including vacations, stereo and television, and magazine and newspaper subscriptions; motor vehicles and motor vehicle repairs; funeral expenses through an irrevocable mortuary trust; legal fees; services of a care manager; and more.
- In some cases, excess resources can be transferred to third parties to preserve eligibility for public benefits, but proceed with caution. There is an SSI transfer penalty, which is calculated by dividing the value of the transfer by the maximum SSI payment, currently $733. Example: A transfer of only $20,000 by an SSI recipient results in a 27-month period of ineligibility for SSI and the possible forfeiture of the SSI-linked Medicaid. But if the individual is not receiving SSI, has Medicaid based on a waiver program, and is not receiving an institutional level of care, there is no Medicaid transfer penalty. This should only be considered if there is no likelihood of a need for long-term care within the five years following the transfer.
Keep in mind some benefits do not have income and asset limits, particularly SSDI and Medicare. (See footnote 1.) These are insurance-based public benefits. The individual who worked and paid payroll taxes (or was the dependent of someone who did) is entitled to the benefits regardless of his or her assets. Individuals can receive inheritances, personal injury settlements, and assets from other sources with no risk to these insurance-based public benefits.  

3. Which Trust to Use?

Once it is determined that a special needs trust is appropriate, the next question is which type of special needs trust should be considered. Although special needs trusts can be distinguished from one another in many ways, the most important distinction is between first party trusts and third party trusts.

A. First Party Special Needs Trusts

First party special needs trusts are funded with assets that belong to the individual for whom the trust is being created. These trusts are referred to by several other names, all of which provide hints to their genesis and creation. They may be referred to as *self-settled special needs trusts* since these trusts are funded with assets that belonged to the trust beneficiary or to which the beneficiary was legally entitled. They are also referred to as *d4A trusts*. This name is a nod to the section of the Omnibus Budget Reconciliation Act of 1993 by which Congress recognized and codified this type of self-settled special needs trust. These first party trusts may also be called *payback trusts* or *under-65 trusts*, and both names reference the statutory requirements imposed by 42 U.S.C. §1396p(d)(4)(A).

A first party special needs trust is considered when an individual with disabilities owns or acquires assets and wants to become or remain eligible for means-tested public benefits. The assets might be in the form of a personal injury settlement or award, possibly resulting from the incident that caused the disability. Assets sometimes include a bequest from a parent, grandparent, or other caring friend or relative who did not know about or have the opportunity to create a third party trust. The same third party could also have named the individual (instead of a

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3 In some cases, a trust may be appropriate for the individual who does not have means-tested public benefits but who is not good at managing money. The individual could accept the assets and then transfer them to a third party who then establishes a support trust for the benefit of the individual. It would not have the typical special needs trust provisions.
third party trust) as the beneficiary of a life insurance policy, annuity, or retirement account. Additionally, a first party special needs trust can be used for alimony or property division in a divorce and for child support payments when a child of the divorcing parents has special needs.

In all of these cases, if the individual receives these assets outright and cannot spend them down below the $2,000 SSI threshold within the month of receipt, he or she will be ineligible for SSI and other benefits, especially Medicaid. But if the assets are transferred to a properly established trust, the “windfall” will be used at the trustee’s discretion to benefit the individual without jeopardizing eligibility for government benefits.

Although this article focuses on special needs trusts established for the benefit of one individual under 42 U.S.C. §1396p(d)(4)(A), first party assets can also be directed to an already existing pooled trust established pursuant to 42 U.S.C. §1396p(d)(4)(C). These are also OBRA 93 trusts and subject to stringent statutory criteria.

The OBRA 93 statutory criteria for a first party special needs trust (see Section 4B) are essentially a “deal” Congress made with individuals with disabilities. Individuals who are otherwise eligible for means-tested public benefits remain eligible despite availability of their assets (at the trustee’s discretion) in the first party special needs trust that meets the statutory criteria.

4 20 C.F.R § 416.1207(d).
5 Most readers of this article are not likely to be involved in the creation of pooled trusts (also known as d4C trusts), so this article will not focus on that topic. But it is interesting to note the statutory criteria any first party pooled trust must meet pursuant to 42 U.S.C. §1396p(d)(4)(C) for the trust assets to not be considered countable to the beneficiary and for the transfer of assets to an account at such a pooled trust to not be treated as a transfer of resources for less than fair market value. Criteria for a d4C trust are:

(i) The trust is established and managed by a non-profit association.

(ii) A separate account is maintained for each beneficiary of the trust, but, for purposes of investment and management of funds, the trust pools these accounts.

(iii) Accounts in the trust are established solely for the benefit of individuals who are disabled (as defined in section 1382c(a)(3) of this title) by the parent, grandparent, or legal guardian of such individuals, by such individuals, or by a court.

(iv) To the extent that amounts remaining in the beneficiary’s account upon the death of the beneficiary are not retained by the trust, the trust pays to the State from such remaining amounts in the account an amount equal to the total amount of medical assistance paid on behalf of the beneficiary under the State plan under this subchapter.

Emphasis is added above to highlight that the individual with disabilities himself or herself may establish the account in the d4C pooled trust. An account at a pooled trust is typically created through a joinder agreement that the intended beneficiary may sign. As discussed below, the individual may not establish his or her own d4A trust.
criteria. One of the chief criteria is the inclusion of a “payback” provision: when the special needs trust beneficiary dies, remaining assets in a first party special needs trust must be available to reimburse any state that provided medical assistance to the beneficiary. Under this legislative deal, the individual’s payment for his or her own medical care is deferred until death. At that point, the state is reimbursed dollar-for-dollar, and no interest is charged. Since the Medicaid reimbursement rate is almost always less than the private pay rate, the use of a first party special needs trust is like getting an interest-free, subsidized loan from the state Medicaid agency. And if there are no remaining trust assets, the state is never reimbursed.

For considerations in drafting a first party special needs trust pursuant to 42 U.S.C. §1396p(d)(4)(A), see Section 4B of this article.

B. Third Party Special Needs Trust

A third party special needs trust is funded with the assets of someone other than the trust beneficiary. This donor wants to provide for an individual with disabilities without jeopardizing that individual’s eligibility for means-tested public benefits. Features that distinguish a third party trust from a first party trust include:

- A third party special needs trust will never be a “self-settled” trust; it is established by a third party and funded with the assets of one or more third parties for the benefit of the individual with disabilities. It should never accept any assets of the individual with disabilities. In fact, doing so likely “pollutes” the trust and makes the trust assets countable, thereby disqualifying the individual from means-tested public benefits.

- A third party trust does not have to comply with strict statutory criteria like those imposed on a first party trust. OBRA 93 specifically excludes trusts established under a decedent’s will and trusts established by someone other than the individual (or his or her spouse) from the definition of “trust.”

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6 Section 1396p(d)(2)(A) provides:

For purposes of this subsection, an individual shall be considered to have established a trust if assets of the individual were used to form all or part of the corpus of the trust and if any of the following individuals established such trust other than by will:

(i) The individual.

(ii) The individual’s spouse.
There is no “payback.” That is, there is no requirement that trust corpus remaining in a third party special needs trust after the beneficiary’s death be reimbursed to states that provided medical assistance to the beneficiary.

A third party special needs trust can be drafted to benefit more than one beneficiary.

A third party trust may be a testamentary trust established in a will or it may be established in a freestanding (or standalone) trust agreement.

A third party special needs trust is usually considered in the context of estate planning for a loved one. It is proactive rather than reactive. For example, suppose a parent died intestate or prepared a simple will with no planning for her child with disabilities who is dependent on SSI and Medicaid. The mother’s assets will be distributed outright to the child who will then lose eligibility. It is possible that one of the alternatives to a special needs trust, described in Section 2, will be appropriate. If not, then to protect the child’s future public benefits, a first party trust with payback provisions will typically be considered. This is a reaction to the circumstances. If it is to be a d4A trust (as opposed to a d4C pooled trust), the other parent, a grandparent, a guardian, or a court will need to establish the trust. And whether it is a d4A or a d4C trust, it will need to include a payback provision.

With proactive estate planning for the child, grandchild, or other loved one with disabilities, the testator (in a will) or the settlor (in a standalone trust) has these opportunities: to hand-pick the trustee and the successor trustees; to highlight objectives for the trust assets either within the trust document or in a separate letter of intent; and to decide how any trust assets remaining on the death of the beneficiary of the special needs trust will be distributed, whether to other descendants or to charities. For considerations in drafting third party special needs trusts see Section 4C.

(iii) A person, including a court or administrative body, with legal authority to act in place of or on behalf of the individual or the individual’s spouse.

(iv) A person, including any court or administrative body, acting at the direction or upon the request of the individual or the individual’s spouse.

Just as there are pooled trusts for first party funds, there are also third party pooled trusts administered by nonprofit agencies. Since these are not funded with the assets of the individual with disabilities, they are not governed by 42 U.S.C. §1396p(d)(4)(C) and need not (but might) include payback provisions. Planning to leave an inheritance for a loved one in an account in a pooled trust has these chief advantages: the trust is already in existence and the trustee will likely be a panel of volunteers with expertise in public benefits, taxes, and financial planning.  

Another form of third party trust is what may be referred to as a convertible trust. Clients may want to provide for a loved one but are unsure whether that loved one will be dependent on means-tested public benefits in the future. In that case, the estate planning vehicle (whether will or freestanding trust) may begin as a support trust that is flexible enough to convert to a discretionary special needs trust in the future.

C. Sole Benefit Trust

As described above, most special needs trusts can be identified as either a first party (self-settled) trust or a third party trust, and both types seek to preserve eligibility for means-tested public benefits for the intended beneficiary. The sole benefit trust considers the eligibility for public benefits for both the settlor and the beneficiary. The statutory authority for sole benefit trusts is OBRA 93, codified at 42 U.S.C. § 1396p(c)(2)(B). It exempts from the Medicaid transfer penalty assets that

(i) were transferred to the individual’s spouse or to another for the sole benefit of the individual’s spouse,

(ii) were transferred from the individual’s spouse to another for the sole benefit of the individual’s spouse,

(iii) were transferred to, or to a trust (including a trust described in subsection (d)(4) of this section) established solely for the benefit of, the individual’s child described in subparagraph (A)(ii)(II), or

(iv) were transferred to a trust (including a trust described in subsection (d)(4) of this section) established solely for the benefit of an individual under 65 years of age who is disabled (as defined in section 1382c(a)(3) of this title).

Trusts established under these provisions are sometimes referred to as c2B trusts, which is a reference to section 1396p(c)(2)(B).

Sole benefit trusts are often used when an older parent of a child with disabilities needs long-term care that could be paid for with Medicaid benefits. Unlimited assets may be transferred from the parent to a properly drafted trust for the benefit of a child with disabilities. The state Medicaid agency will not impose a Medicaid transfer penalty on the parent whose assets were transferred, and the establishment of the trust will not disqualify the beneficiary from means-tested public benefits. Note that a parent-child relationship is not required. In fact, there need not be any familial relationship between the grantor and the beneficiary for a sole benefit trust to comply with section 1396p(c)(2)(B).

The fact that the trust is created by and funded with the assets of a third party make this type of trust similar to a third party trust. But, the trust must satisfy the requirement that the trust be “solely for the benefit of” the beneficiary, and the way that requirement is interpreted by state Medicaid agencies and satisfied in the trust makes it similar to a first party trust.9 For recommendations on drafting a sole benefit trust that meets the criteria of section 1396p(c)(2)(B)(iv), see Section 4D of this article.

(This article continues on the following page.)

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9 For an in-depth discussion of these trusts, see The Sole Benefit Trust: the “Forgotten” Trust by Howie S. Krooks, Esq., which was presented at Stetson University’s 2012 Special Needs Trust National Conference.
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<tbody>
<tr>
<td>Established by whom?</td>
<td>By a court or by a parent, grandparent, or guardian of the settlor/grantor</td>
<td>By a third party, typically a parent or grandparent of the intended beneficiary</td>
<td>By a third party (often a parent of the intended beneficiary) who seeks eligibility for means-tested public benefits</td>
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<tr>
<td>With whose funds?</td>
<td>The intended beneficiary with his or her own funds</td>
<td>One or more third parties with their own funds</td>
<td>One or more third parties with their own funds</td>
</tr>
<tr>
<td>Who is true grantor?</td>
<td>The intended beneficiary with his or her own funds</td>
<td>One or more third parties with their own funds</td>
<td>One or more third parties with their own funds</td>
</tr>
<tr>
<td>For the “sole benefit” of one beneficiary</td>
<td>Yes</td>
<td>Not necessarily</td>
<td>No</td>
</tr>
<tr>
<td>Payback provisions required?</td>
<td>Yes</td>
<td>No</td>
<td>Possibly, subject to state interpretation</td>
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<td>Required to be actuarially sound?</td>
<td>No</td>
<td>No</td>
<td>Possibly, subject to state interpretation</td>
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<tr>
<td>Age limit?</td>
<td>Must be established for a beneficiary under age 65</td>
<td>No</td>
<td>Must be established for a beneficiary under age 65</td>
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<td>Revocable or irrevocable?</td>
<td>Must be irrevocable</td>
<td>May be revocable or irrevocable</td>
<td>Must be irrevocable</td>
</tr>
<tr>
<td>Typical uses?</td>
<td>Protect eligibility for means-tested public benefits after receipt of personal injury award or settlement, unplanned for inheritance, or “windfall”</td>
<td>Estate planning for a loved one who does or may rely on means-tested public benefits</td>
<td>Medicaid planning for the grantor/settlor who wants to benefit a loved one who relies on means-tested public benefits</td>
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<td>Reactive or proactive?</td>
<td>Reactive</td>
<td>Proactive</td>
<td>Reactive and proactive</td>
</tr>
<tr>
<td>Subject to review by public benefits agencies?</td>
<td>Yes, in determining eligibility of beneficiary</td>
<td>Yes, in determining eligibility of beneficiary</td>
<td>Yes, in determining eligibility for grantor and beneficiary</td>
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4. Drafting Considerations

A. Starting Principles

Although the various types of special needs trusts have different etiologies and serve many different purposes, some general observations may be made for drafting any type of special needs trust.

First, it should go without saying that the drafter must be knowledgeable about and remain abreast of the law and regulations regarding special needs trusts. One way to stay up-to-date is to attend Stetson University’s annual Special Needs Trust National Conference. In addition to having a finger on the pulse of trends in special needs trusts nationally, the drafter must also be fluent in local state trust and probate law and the idiosyncrasies of the local Medicaid agency.

Second, it is also a baseline principle that the individual circumstances of the intended special needs trust beneficiary must be taken into account. Never rely on a client’s representation of the benefits being received by the beneficiary. Verify all means-tested public benefits to which the intended beneficiary is or may be entitled - SSI, SSDI, childhood disability benefits (CDB), Medicaid, Medicare, VA, housing assistance (e.g. Section 8), Supplemental Nutrition Assistance Program (SNAP, commonly referred to as food stamps), Low Income Home Energy Assistance Program (LIHEAP) - and insist on documentation from the government agency. Do you understand the eligibility rules for each benefit? Will the existence of a special needs trust and different types of distributions from a special needs trust (e.g. food and shelter vs. clothing and car expenses) affect eligibility?

Third, understand your client’s goals, options, and individual circumstances. Could assets be spent down? Could the individual with disabilities accept the funds outright and purchase insurance not available prior to the Affordable Care Act? If the assets to be set aside are modest and if the donor wants the individual to have autonomy, could an ABLE Act account be sufficient? If family members are being suggested to serve as the trustee, are they really suitable for the role?

Fourth, incorporate flexibility. The circumstances of the beneficiary may change, and the law and rules regarding public benefits will change. Some ways to draft for flexibility include:
✓ Using trust protectors, advisory committees, and other advisors who may have powers to amend the trust. In the alternative and if necessary, allow for amendment by the court.
✓ Include decanting provisions as appropriate to allow for the transfer of assets into a new trust without court involvement.
✓ Include merger provisions to allow consolidation of trusts that have the same purpose and structure. (Remember: A first party and a third party special needs trust would never be merged.)
✓ Depending on the settlor’s goals, a freestanding third party special needs trust may be drafted to reserve to the settlor the powers to amend and revoke.
✓ Where appropriate, consider including powers of appointment.

Once the trust is established, the drafter should submit the document to the state Medicaid agency and the Social Security Administration to request approval of the trust agreement. This is necessary if the beneficiary is already receiving SSI and Medicaid.10

B. Drafting a First Party Special Needs Trust

Assets owned by the individual and transferred to a trust will be countable to that individual for the purpose of determining eligibility for SSI and Medicaid. But in 42 U.S.C. §1396p(d)(4), Congress exempted certain trusts from this rule, including

A trust containing the assets of an individual under age 65 who is disabled (as defined in section 1382c(a)(3) of this title) and which is established for the benefit of such individual by a parent, grandparent, legal guardian of the individual, or a court if the State will receive all amounts remaining in the trust upon the death of such individual up to an amount equal to the total medical assistance paid on behalf of the individual under a State plan under this subchapter.

From its statutory foundation, the d4A trust must meet the following criteria:

✓ The trust must be funded with the assets of the individual who will be the sole beneficiary of the trust during his or her lifetime.

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10 On April 28, 2014, the SSA implemented a process so that review of all trusts submitted for SSI claims and post-eligibility actions will be made in field offices.
✓ The trust beneficiary must be under age 65 when the trust is established. Assets in the trust will remain exempt for the purpose of Medicaid eligibility after age 65, but any assets transferred into the trust after age 65 will be countable.

✓ The trust beneficiary must be disabled as defined by the Social Security Act in 42 U.S.C. § 1382c(a)(3). If the individual is not already receiving SSI or Medicaid, the disability will have to be confirmed by the Disability Determination Service.

✓ At present, the trust must be “established” pursuant to a court order or by a parent, grandparent, or guardian of the beneficiary. The trust may not be established by the beneficiary,\(^\text{11}\) which results in one of the oddities of d4A trusts. Although the beneficiary is the “grantor” of the trust as his or her assets will fund the trust, the beneficiary cannot sign the trust document and cannot fund the trust directly.\(^\text{12}\)

✓ The trust must include a payback provision which provides that state Medicaid agencies will receive all amounts remaining in the trust upon the death of the beneficiary up to the amount of medical assistance paid since birth, not just since the event creating the disability or since creation of the trust. Only two categories of expenses have priority to the Medicaid payback: state or federal taxes due because of inclusion of the trust in the beneficiary’s estate, and reasonable fees for administration of the trust estate. If more than one state has provided benefits, the amount available will be prorated. If there are any trust assets remaining, other expenses of the trust may be paid (e.g., funeral expenses, debts owed to third parties) and then the balance may be distributed to remaindermen.

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\(^\text{11}\) The Special Needs Fairness Act seeks to enable competent individuals to establish their own special needs trusts. It was passed unanimously by the Senate on September 9, 2015. The National Academy of Elder Law Attorney’s Public Policy Manager tracks progress on the Special Needs Trust Fairness Act of 2015 (H.R. 670/S. 349) at https://www.naela.org/Public/Advocacy_Public_Policy/Public_Policy/SNT_Fairness_Act.aspx.

\(^\text{12}\) The reader is encouraged to consider the materials presented by Patty Stichler at Stetson University’s 2015 Special Needs Trust National Conference regarding the 8th Circuit U.S. Court of Appeals’ decision in Draper v. Colvin, No. 13-2757 (March 3, 2015), and the unnecessarily contorted complexities imposed by the SSA in the creation and funding of d4A trusts.
In addition to tracking the statute, the drafter must also consult the SSA’s Program Operations Manual System. For example, although not required by statute, the POMS requires that a self-settled special needs trust be irrevocable.\textsuperscript{13}

\textbf{C. Drafting a Third Party Special Needs Trust}

A third party trust can take several forms. It is commonly a testamentary trust included in a will. In fact, this structure (as opposed to a revocable living trust) must be used in the context of Medicaid planning when a community spouse (typically the healthier spouse) intends to preserve assets from the long-term care expenses of the other spouse in the event that the community spouse dies first. The will provides that all or a portion of the deceased spouse’s assets will be held in the testamentary trust for the lifetime of the surviving spouse and be used to supplement and not supplant public benefits, subject to the discretion of the trustee. Upon the death of the surviving spouse, the remaining trust assets will be distributed as the community spouse provided in his or her will, typically to the couple’s descendants.

The testamentary trust for the benefit of a surviving spouse must be drafted with an eye to Medicaid regulations and procedures in the state where the surviving spouse is likely to reside after the death of the community spouse. Some states treat the failure of the surviving spouse to pursue any statutory spousal elective share or statutory exemptions and allowances as transfers of assets for less than fair market value. The value of what the surviving spouse failed to pursue and collect will be subject to a transfer penalty.\textsuperscript{14}

A third party special needs trust for the benefit of anyone other than a surviving spouse can be established in a will or in a freestanding trust that comes into existence during the lifetime of the grantor. The trust could be revocable or irrevocable, depending on the goals of the settlor as well as tax considerations. There are several benefits to this, including coordinating lifetime or testamentary gifts from several sources. For example, a divorced couple may both want to

\textsuperscript{13} SI POMS 01120.200(D)(1)(a): Trusts – General, Including Trusts Established Prior to 1/1/00, Trusts Established with the Assets of Third Parties and Trusts Not Subject to Section 1613(e) of the Social Security Act, https://secure.ssa.gov/poms.nsf/lnx/0501120200.

\textsuperscript{14} In Maine, a surviving spouse is entitled to one-third of the augmented estate of the decedent spouse as well as to statutory exemptions and allowances currently totaling $29,000. The Department of Health and Human Services will impose a transfer penalty if the surviving spouse fails to receive this amount from the estate of the first-to-die spouse.
provide for a child. They could agree to establish a third party special needs trust for that child’s benefit, which initially may be only minimally funded. Each parent could have their respective estates (through wills, revocable living trusts, and beneficiary designations) direct assets to the trust upon death. And grandparents or siblings of the child with disabilities could do the same. A third party trust will be established in the context of a client’s estate plan so consideration must be given to the client’s other estate planning goals and intended beneficiaries as well as to gift, estate, and income tax issues.

D. Drafting a Sole Benefit Trust

As the term is used in this article, a sole benefit trust is established by one person who seeks to become or remain eligible for means-tested benefits by transferring assets for the benefit of an individual with disabilities. The individual who will be the beneficiary must have been determined to be disabled pursuant to the Social Security definition of disability found in 42 U.S.C. § 1382c(a)(3).

For the transfer to not result in a transfer penalty for the settlor, the trust must satisfy the “solely for the benefit of” requirement of 42 U.S.C. § 1396p(d)(4)(C)(iv). States have interpreted this requirement differently, so it is essential that the drafter be aware of the idiosyncrasies in the relevant state. For example, the Maine Department of Health and Human Services takes the position that a sole benefit trust must either include payback provisions or be “actuarially sound.”

If the sole benefit trust uses a payback provision, it will be similar to those used in a d4A trust. It must provide that funds remaining in the trust upon the death of the beneficiary are available to reimburse the state up to the amount of medical assistance paid on the trust beneficiary’s behalf.15 (Again, if the beneficiary received medical assistance in more than one jurisdiction, the jurisdictions will be reimbursed proportionately.) During the beneficiary’s lifetime, the trust must be solely for the beneficiary’s benefit. But if trust assets remain after the payback, named remaindermen could receive the remaining trust assets.

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15 HFCA Transmittal 64 3257(B)(6).
If the trust is designed to be “actuarially sound” to meet the “solely for the benefit of” requirement for a sole benefit trust, it must provide that the trust will be paid out over the life expectancy of the beneficiary. In Maine, the inclusion of the following language satisfies the Medicaid agency: “I intend that the trust assets be expended during Dorothy’s lifetime, and the Trustee shall make such expenditures on an actuarially sound basis considering Dorothy’s life expectancy.” The trustee is required to make distributions at least annually but has the discretion to distribute more rapidly.

Whether a payback provisions or an actuarially sound provision is what is included in a particular trust requires consideration of the individual beneficiary’s circumstances, including his or her realistic life expectancy, the extent to which the state has and continues to provide medical assistance, and whether the beneficiary receives SSI benefits that would be disrupted with actuarially sound distributions (unless the trust provides that distributions cannot be used for food and shelter). If the beneficiary is receiving means-tested public benefits, the drafter will need to draft the trust in accordance with the third party trust rules in the state where the beneficiary resides.

5. Conclusion

This article provides an introduction to the differences in purpose, structure, and creation of first and third party special needs trusts. A special needs trust is intended to improve the quality of life for an individual with disabilities, but a poorly drafted special needs trust or the wrong type of special needs trust for a particular situation can disqualify the beneficiary for much-needed, means-tested public benefits and disrupt his or her network of support. The reader is strongly encouraged to consult other resources, to mentor with experienced practitioners, and to stay current with changes in the ever-evolving arena of tax law, trust law, and public benefits.