

Making a Trust a Special Needs Trust - Whens, Whys & Hows

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I. INTRODUCTION

This material is an overview of what makes a trust a “special needs trust”, one that is used for people who are elderly or have a disability that will allow them to qualify for public assistance benefits such as Medicaid and Supplemental Security Income (SSI).

Although these materials refer to such a trust as a “special needs trust,” there is no universally accepted name for such trusts. Over the years numerous authors, agencies and courts have used various names, including "supplemental needs trusts," "supplemental care trusts," “spendthrift trusts,” “d4A trusts”, “discretionary trusts” and many others. Probably the most recognized name is "special needs trusts," although this is actually only one of the distribution standards that can be used for this type of trust.

These materials assume the reader understands the elementary rules concerning what constitutes a trust. However, some of the definitions used throughout these materials will be explained so the reader will be aware of the basic design concepts and be able to classify and distinguish the various types of trusts. Then five of the major public benefit programs will be briefly described and examples will illustrate when it is appropriate to utilize a special needs trust. Lastly these materials will describe how to make a trust a special needs trust.

A. How Trusts Impact Medicaid and SSI Eligibility

When a person applies for Medicaid and/or SSI benefits, he or she must disclose all assets owned and income being received. In addition, if the person is the beneficiary of any trust, the details of

that trust will be reviewed by the agency that administers the public benefit program for which the person is trying to qualify.

Unless the trust meets certain strictly construed criteria, the corpus of the trust will be deemed to be an "available" or "countable" resource to the person. This means it will count towards the maximum amount of non-exempt resources the person can have and still qualify to receive SSI or Medicaid long-term care benefits. For SSI and Medicaid in most states this is no more than \$2,000.

If it is determined that the person has available resources that exceed the maximum amount allowed, he or she will be denied SSI and Medicaid assistance until the excess resources disappear, or are "spent down" to an amount below the maximum allowed. However, if the trust is a properly drafted special needs trust, then the trust will be exempt and the assets held in the trust will not count towards the \$2,000 limit.

B. How to Categorize Trusts

1. Who Established the Trust: All trusts are either self-settled or third party-settled. These are sometimes also referred to respectively as a "first-party trust" and a "third-party trust."

The "settlor" of a trust is not just the person who signs the trust to establish it and is referred to in the trust document as the settlor (or grantor, trustor, or some similar title). It is well-established that a person is considered a settlor of a trust if such person's assets are used to fund the trust. See, for example, Restatement (Second) of Trusts, §3 and §17; 42 U.S.C. §1396p(d)(2)(A); POMS § SI 01120.200.B.2; *Guaranty Trust Co. of New York v. New York Trust Co.*, 297 N.Y. 45, 50-51, 74 N.E.2d 232 (1947).

When considering which type of trust is appropriate for a beneficiary who is receiving public assistance benefits, it is important to distinguish between self-settled trusts and third party-settled trusts. The public assistance programs and the courts treat these types of trusts very differently.

a. **Self-Settled Trust**

1) **Definition:** A self-settled trust is a trust that holds any assets formerly owned by the beneficiary of the trust. This is true even if the beneficiary (or the beneficiary's spouse) did not sign the trust as the person establishing it. In other words, in a self-settled trust the settlor and beneficiary are the same person. In addition, for Medicaid and SSI purposes a trust is deemed to be self-settled if any assets of the beneficiary's spouse are transferred to the trust (42 U.S.C. §1396p(d)(2) and §1396p(h)(1)). The only exception to this is if the spouse establishes the trust by his or her Last Will and Testament (42 U.S.C. §1396p(d)(2)(A)).

Also, even though a guardian or conservator signed the papers to establish a trust for the benefit of a ward, since the ward's assets are put into the trust the ward is deemed to be the true settlor of the trust. This was codified at 42 U.S.C. §1396p(d)(2)(A) when Congress enacted the Omnibus Budget Reconciliation Act of 1993 (OBRA-93) Pub.L.No.99-262.

Since the settlor and beneficiary of a self-settled trust are the same person, a self-settled trust is always established during the settlor's lifetime, and is therefore always a "living trust," sometimes referred to as an "inter vivos trust." Upon the establishment of a living trust the settlor will either reserve the rights to amend and revoke the trust (a "revocable trust") or will not

reserve such rights (an “irrevocable trust”). Either way, the settlor should expressly state in the trust document whether or not such rights are retained. The state law that governs a trust will control the details of the trust, and the states differ on whether a trust that does not say anything about the right to revoke is presumed to be revocable or irrevocable.

2) **Impact on Eligibility for Public Assistance:** If a trust is self-settled then the trust assets will be deemed to be a countable resource for SSI and Medicaid purposes unless the trust fits into one of the three exceptions found in 42 U.S.C. §1396p(d)(4). These are:

- (A) d4A Trust (a/k/a Self-Settled Special Needs Trust or Medicaid Payback Trust),
- (B) Qualifying Income Trust (Miller Trust) (this trust is only used in income cap states and does not only apply to people who have a disability), and
- (C) Pooled Trust (42 U.S.C. 1396p(d)(4)(C)).

3) **Design of Self-Settled Special Needs Trust:** The drafter of a d4A trust needs to strictly satisfy all of the requirements for such a trust imposed by federal law (42 U.S.C. 1396p(d)(4)(A), OBRA-93, Transmittal 64 and decided cases) and by the laws of the state where the trust beneficiary resides. Since these materials focus on third party-settled trusts, a description of the design requirements for a self-settled special needs trust will not be covered in these materials.

b. **Third Party-Settled Trust:** A third party-settled trust is a trust that is not executed as "settlor" by the beneficiary of the trust and is not funded with any assets that belong to the beneficiary, or for Medicaid and SSI purposes, belong to the beneficiary's spouse.

An example of a third party-settled trust is when a parent transfers the parent's assets to a trust for the benefit of the parent's child. This will typically occur at the parent's death as part of the parent's estate plan, but such a trust could also be established and funded during the parent's lifetime.

Technically, it is also a third party-settled trust when a person establishes a trust with the person's separate assets for the benefit of his or her spouse. However, unless established by the Will of the person, such a trust is deemed to be self-settled for both SSI and Medicaid purposes. Both of these programs deem all assets of either spouse to be available to the other spouse.

A third party-settled trust always benefits someone other than the settlor of the trust. It is either established and funded upon the settlor's death (a "testamentary trust") or during the settlor's lifetime (a "living trust"). As with a self-settled living trust, a third party-settled living trust will be either revocable or irrevocable.

Normally a third-party settled trust that has the appropriate distribution standard will not be deemed to be an "available resource" for Medicaid and SSI eligibility purposes.

2. **What Distribution Standard Is Used:** All trusts contain a section that provides guidance to the trustee concerning when and how to distribute trust assets to or for the

benefit of the beneficiary. This section is referred to in these materials as a “distribution standard.”

a. **The Four Distribution Standards of Trusts:** There are actually four distribution standards that may be used in a trust. The two that are most commonly used in trusts are the “support” and “discretionary support” standards. However, these will usually make the trust assets “available resources” to the beneficiary for Medicaid and SSI eligibility purposes. If the settlor’s goal is to keep the trust assets from disqualifying the beneficiary from Medicaid and SSI, then either the “special needs (or supplemental care)” or the “totally (or purely) discretionary” standards should be used. Each of these trust distribution standards is further described below.

1) **Support:** A support trust (sometimes referred to as a "mandatory support trust") is a trust that requires the trustee to pay for the support of the beneficiary. It will almost always contain a requirement that the trustee use the trust funds for the beneficiary's "support," but it may also contain words such as "maintenance," "health care" and "welfare." Use of the traditional ascertainable standard language of "support, maintenance, health care and education" (See IRC Reg. 20-2041-1(c)(2)) coupled with the requirement that the trustee "shall" make distributions from the trust for such purposes, will make the trust a support trust. This is the type of trust that is traditionally used for minors or other beneficiaries who do not have a disability.

Since a support trust has a legally enforceable responsibility to support the beneficiary, the assets of the trust are deemed to be “available” to the beneficiary for public assistance benefits purposes. This means that they will count toward the maximum the beneficiary can own and still be eligible to participate in the Medicaid and SSI programs. If the trust assets exceed this

amount, then the trust alone will disqualify the beneficiary from receiving such benefits.

2) **Discretionary Support:** A discretionary support trust is a trust that gives the trustee discretion whether or not to distribute from the trust for the support of the beneficiary. It is a combination of both the purely discretionary trust (discussed below) and the support trust standards.

Whether a discretionary support trust will be deemed to be an “available resource” is extremely hard to predict, and appears to be heavily based on the actual facts of the situation. Some states do not recognize the concept of a discretionary support trust and will labor to determine if the settlor intended the trust to be a support or a discretionary trust. Often, however, a discretionary support trust will be deemed to be an available resource to the beneficiary.

3) **Purely or Totally Discretionary:** A purely (sometimes referred to as “totally” or “wholly”) discretionary trust is a trust that grants the trustee absolute and total discretion concerning when and how to make a distribution from the trust. It does not impose any standard on the trustee, and even authorizes the trustee to not make any distributions at all.

Some courts have held that the trustee must exercise its discretion in a manner that accomplishes, rather than frustrates, the purposes of the trust (see, for example, *McNiff v. Olmstead County Welfare Dept.*, 176 N.W.2d 288 (Minn. 1970)). This makes it very important to clearly express the purposes of the trust and the intention of the settlor in the trust instrument.

The trust assets in a purely discretionary trust are normally not deemed to be “available resources” to the beneficiary since the trustee has total discretion concerning whether or not to make any distribution from the trust and neither the beneficiary nor any other person has the ability to force the trustee to make any distribution. Occasionally, however, there may be a statute that deems a discretionary trust to be an available resource for Medicaid eligibility purposes. See for example Kansas Statute K.S.A. §39-709(e)(3).

4) **Special Needs:** A special needs trust is a trust that gives the trustee broad discretion to distribute trust income and/or principal for the "special needs" of the beneficiary. Special needs are usually defined as anything the beneficiary needs, or anything that would be useful or in any way helpful to the beneficiary, if it is not paid for or adequately provided to the beneficiary from a public assistance benefit program or some other source. The trustee is directed to distribute from the trust in a manner that “supplements but does not supplant” any public assistance the beneficiary is receiving. These trusts are also sometimes referred to as “supplemental needs trusts,” “supplemental care trusts,” and similar titles.

Strict Special Needs: Some special needs trusts expressly prohibit the trustee from making distributions for the beneficiary's food and shelter, or for anything that will cause a reduction or loss of public benefits. These are referred to as “strict special needs trusts.” Older trusts also contained a prohibition from distributing for the beneficiary’s “clothing.” This was because SSI used to deem such expenditures as in-kind support and maintenance which adversely affected the beneficiary’s SSI benefits. However, since the regulations were changed on March 9, 2005, a

distribution for clothing will no longer adversely impact a beneficiary's SSI.

Discretionary Special Needs: Other special needs trusts give the trustee additional discretion to make such distributions, even if doing so will reduce or cut off public assistance benefits, if the trustee deems such distribution to be in the best interests of the beneficiary. These are referred to as "discretionary special needs trusts."

Unless the applicable state law will make such a trust an "available resource" it is usually better to utilize the discretionary special needs trust standard since it allows the trustee to be more flexible in making distributions. An example would be allowing a special needs trust beneficiary to live rent free in housing paid for by the trust, even though this will cause a reduction of the beneficiary's SSI.

A special needs trust does not disqualify the beneficiary from SSI or Medicaid because the trustee is not required to distribute for something that is provided by a public assistance program and, therefore, the assets held in the trust are not deemed to be "available resources" for Medicaid and SSI purposes.

C. **Summary of Five Major Public Benefit Programs**

Although most of the details are beyond the scope of these materials, the basic criteria of five of the major public assistance programs a person may be eligible for are as follows:

1. **Programs Not Based on Financial Needs:** Participation in these two programs is not based on whether a person has minimal assets or income, but only on whether the person

meets certain non-financial criteria established by the program. If a trust beneficiary only participates in these two programs, and none of the need based programs, then it is not necessary to utilize a special needs trust.

a. **Social Security:** Social Security benefits may be old-age assistance (retirement benefits), survivor's benefits, or disability benefits. This program is officially known as Old Age, Survivors, and Disability Insurance (OASDI). The law is found at 42 U.S.C. §401, et seq., and 20 C.F.R. §404, et seq.

A person may draw Social Security benefits from his own Social Security earnings record or someone else's. In certain circumstances, it is possible for a person to receive Social Security benefits based on the Social Security earnings record of the person's spouse, parent or child. Social Security pays money to a recipient on a monthly basis.

Since qualification for Social Security benefits is not based on the amount of resources or unearned income a person has, it does not matter if a Social Security recipient is the beneficiary of a trust or has other assets. For all Social Security benefits other than Social Security Disability, income from any source will not reduce the benefits received, although it may make some of the Social Security benefits taxable. Persons receiving Social Security Disability, however, will find their benefits reduced or terminated if they are able to earn a sufficient amount of money from employment.

b. **Medicare:** Medicare is a health insurance program that provides for hospitalization, most doctor's charges, some skilled nursing home care, and some home care. The law is found at 42 U.S.C. §1395, and 42 C.F.R. §405-421. It is

administered by the Centers for Medicare and Medicaid Services (CMS, formerly known as the Health Care Financing Administration (HCFA)).

The only criterion to be eligible for Medicare is to be either age sixty-five or older, have been a recipient of Social Security Disability (SSD) benefits for at least twenty-four months (this is waived for a person who has ALS), or have end-stage renal disease requiring renal dialysis or a kidney transplant. Participation in Medicare is not based on a person having minimal assets or income.

2. **Programs That Are Need Based:** Although participation in the above described programs is not adversely impacted by a person having too many assets or income, there are other public assistance programs that are “need based.” In other words, a person does not qualify for these other programs unless the person meets certain criteria, two of which are having low income and minimal assets “available” (some programs use the word “countable”) to the person. Two of these programs are Supplemental Security Income (SSI) and Medicaid.

a. **Supplemental Security Income (SSI):** SSI is a federal program administered by the Social Security Administration. The law is found at Title XVI of the Social Security Act, 42 U.S.C. §1381, et seq., and 20 C.F.R. §416. The Social Security Administration also has an operations manual to guide its caseworkers. It is called the Program Operations Manual System (POMS). It can be found online on the Social Security Administration’s website.

SSI is designed to pay a minimum amount of income to qualified individuals to provide for all of their food and shelter. In order to be eligible for SSI a person must meet the categorical requirements of being at least age sixty-five, blind, or permanently and totally disabled. In addition, the person's income must be below the

SSI benefit amount. Another requirement is that the person's "countable resources" must be Two Thousand Dollars (\$2,000.00) or less. Similar to the Medicaid program, certain resources are deemed to be exempt.

b. Medicaid: Medicaid is a welfare program that is a partnership between the United States government and the states. The federal law is found at Title XIX of the Social Security Act, 42 U.S.C. §1396 and 42 C.F.R. §430, §431 and §435. Each state will also have its own statutes and regulations dealing with its Medicaid program. The federal agency administering the Medicaid program is the Centers for Medicare and Medicaid Services (CMS, formerly known as the Health Care Financing Administration (HCFA)). Each state will have a department that administers the Medicaid program in that state. The state Medicaid agency will usually also have a manual to guide its employees.

Similar to SSI, to become eligible to receive Medicaid benefits a person must be over age 65, blind or sufficiently disabled, have low income and available resources of \$2,000 or less in most states. Although there are many programs offered by the various states, essentially Medicaid provides medical and long-term care assistance.

3. Veterans Benefits: A person may be eligible to receive benefits from the Veterans Administration or one of the branches of the United States military. Eligibility to receive such benefits may be dependent on the person's financial condition, depending on the particular benefits being applied received.

II. WHEN TO USE A SPECIAL NEEDS TRUST

A special needs trust is used when the person benefitting from the trust (the beneficiary) is sufficiently disabled to qualify for need based public assistance programs, such as Medicaid, SSI and

some Veterans benefits. The purpose of the trust is to allow money and other assets to be held for benefit of the beneficiary in such a manner that the trust assets are not deemed to be “available” to the beneficiary and therefore are not “countable” towards the maximum amount the beneficiary can have and maintain eligibility for the public assistance program.

A. When the Beneficiary Puts His Own Money into the Trust: When money or an asset owned by the beneficiary of the trust or the beneficiary’s spouse is put into a trust it is classified as a self-settled trust. The only types of self-settled trusts that actually work as a special needs trust are those that qualify as either a d4A trust authorized by 42 U.S.C. 1396p(d)(4)(A) or a pooled trust authorized by 42 U.S.C. 1396p(d)(4)(C). A self-settled special needs trust is typically utilized in the following situations:

1. **Personal Injury Award:** A self-settled special needs trust may be used when a person who has a disability receives a personal injury award. Assuming the person was so severely disabled that the person cannot effectively manage his or her own assets, the traditional approach was to establish a conservatorship (sometimes referred to as a guardianship for property) to hold the award and assure it was used for the benefit of the person who has the disability. However, conservatorship assets are deemed to be "available" to the conservatee for Medicaid and SSI eligibility purposes, so the award would have to be "spent down" before such public assistance would be available. In addition to effectively wasting the award, in many cases this also has the effect of cutting the person who has the disability off from participating in programs that would be very helpful to the person, but that must give first priority to persons eligible for Medicaid.

2. **Inheritance and Gifts:** If a person who has a disability receives an inheritance or gift that is large enough to disqualify the person from Medicaid and SSI, the inheritance or gift can be transferred to a self-settled special needs trust by the person or his representative.

In this instance, the person making the gift should have created their own third party-settled special needs trust to hold the gift or inheritance. By doing so the money could have been used to supplement the benefits of the person who has the disability without rendering her ineligible for Medicaid and SSI. Also, at the death of the person who has the disability any assets remaining in the special needs trust could have gone to other individuals rather than to the state to reimburse the Medicaid program. However, once the gift is made directly to the person who has the disability, it is too late to put it into a third party-settled trust.

Sometimes an inheritance can be disclaimed by the person who has the disability. However, most states treat a disclaimer as a “disqualifying transfer” for Medicaid eligibility purposes.

3. **Accumulated Assets:** There are two situations when it may be appropriate to transfer assets that have been accumulated in the name of a person who has a disability to a self-settled special needs trust.

a. **Minor Person With a Disability:** Often well-meaning parents or other relatives will make gifts to a minor child who has a disability through Uniform Transfers to Minors Act accounts, traditional minor's trusts, outright, or in joint name with the child. Once the child reaches 18 years of age and would otherwise qualify for Medicaid and SSI, these assets will be deemed to be available to the child and will have to be "spent down" before the child is eligible for such programs. As an alternative to spending the money, a self-settled special needs trust can be established and the custodian, trustee or child can transfer the assets to this trust.

b. **Adult Recently Disabled Person:** An adult who is not disabled and who has accumulated assets and investments over his or her lifetime may become disabled as a result of an accident or illness. All of the assets that had been accumulated are now available resources for Medicaid and SSI purposes and will have to be "spent down"

to qualify. Depending on the situation, it may be possible to transfer these assets to a self-settled special needs trust that will not disqualify the recipient from Medicaid and SSI.

B. When Someone Other Than the Beneficiary Puts Money in the Trust: A third party-settled special needs trust is used when a person (a “third party”) wants to put assets into a trust that benefits a different person (the “beneficiary”) who is sufficiently disabled to qualify for need based public assistance programs (such as Medicaid and SSI) and the person establishing the trust does not want the trust assets to count as an “available resource” for purposes of the beneficiary’s eligibility for such programs.

The most common situation when a third party-settled special needs trust is used is when a parent wants to leave assets upon the parent’s death in trust for the benefit of a child who is sufficiently disabled to qualify for Medicaid or SSI assistance. However, this type of trust is also used when grandparents, other relatives or friends want to give assets to a person who has a disability without adversely impacting the person’s eligibility for public assistance.

III. HOW TO MAKE A THIRD PARTY-SETTLED TRUST A SPECIAL NEEDS TRUST

A third party-settled special needs trust is nothing more than a normal third party-settled trust that contains a special needs distribution standard and some unique provisions, and removes some of the standard provisions that are often found in non-special needs trusts. It can be a testamentary trust established by a person’s Will, or a revocable or irrevocable living trust. If a living trust, it can be standalone or inside a person’s general living trust that distributes all of the person’s estate upon death. Advantages and disadvantages of these options are discussed later in these materials. The point to be made here is that the starting place when drafting a special needs trust is the same document that would be used to establish any third party-settled trust.

A. **Required Clauses for a Special Needs Trust:** Some of the clauses that are mandatory when designing a special needs trust are described below.

1. **Settlor's Intent:** It is extremely important that the trust instrument clearly state that the settlor intends that the trust estate not disqualify the beneficiary from need based public assistance, but instead supplement such benefits. If a court is ever asked to interpret a trust, it will interpret questionable provisions in a way that carries out the intent of the settlor. See, for example, *Tidrow v. Dir., Missouri State Division of Family Services*, 688 S.W. 2d 9 (Mo. App. E.D. 1985). The following language is an example of such a clause.

Purpose and Intent: The purpose and intent of this Trust is to create a fund to be used at the Trustee's sole and absolute discretion for the supplemental care of the beneficiary and not to displace financial or other assistance, such as Medicaid and SSI, that may otherwise be available to the beneficiary."

2. **Special Needs Distribution Standard:** The distribution standard used in the trust must be a special needs standard, preferably discretionary rather than strict. In most cases, the only reason a strict special needs standard would be used is when the beneficiary resides in a state that requires such a standard in order to treat the trust as an exempt trust for Medicaid eligibility purposes. A sample clause illustrating this is as follows:

Distributions: The Trustee may distribute as much of the income and principal of the trust estate, even to the point of distributing all or none of it, as the Trustee in its sole and absolute discretion, may from time to time deem necessary or advisable to satisfy the beneficiary's supplemental needs (as defined below) and to supplement and enhance what the beneficiary is receiving from any governmental agency, including but not limited to, the Medicaid program. Any income not distributed shall at least annually be

added to and become a part of the principal. As used in this instrument, the term "supplemental needs" refers to those items needed for the beneficiary to maintain good physical and mental health, welfare, healthy companionship, and safety when, in the opinion of the Trustee, such items are not being adequately provided by any governmental agency, office or department of the United States or any state government, including but not limited to, the Medicaid program. "Supplemental needs" may include, but are not limited to, clothing and equipment; programs designed to provide the beneficiary with education, training, recreation and treatment; medical and dental expenses; and essential dietary needs. In addition, the Trustee may provide in-kind income to the beneficiary from this Trust, including in-kind support and maintenance, if the Trustee, in its sole and absolute discretion, determines such action is in the beneficiary's best interest. Other examples are described later in this instrument.

The settlor prefers that the trust estate not be distributed in such a manner that any governmental financial assistance which would adequately provide for the beneficiary if this Trust did not exist is in any way reduced, diminished, altered or denied. All terms of this Trust, wherever they may appear, shall be interpreted to conform to this primary goal. However, a distribution, including, but not limited to, in-kind support and maintenance, may be made by the Trustee, in the Trustee's sole and absolute discretion, in order to meet a supplemental need of the beneficiary that the Trustee believes is not otherwise adequately met by governmental assistance."

3. **Broad Trustee Discretion:** The trustee should be granted very broad discretionary powers. Often the phrases "sole and absolute" or "unfettered" are used. For example, consider the following:

“The Trustee is hereby granted authority to make or not make any distribution from the trust estate to or for the benefit of the beneficiary that the Trustee, in its sole, absolute and unfettered discretion, determines is appropriate, even to the point of distributing all or none of the trust estate, and any such decision shall not be subject to court review or challenge by any person.”

The purpose of this is to allow the trustee to make decisions about whether or not to distribute from the trust for the benefit of the beneficiary who has a disability without the Medicaid or SSI caseworker or a court being able to question the distribution on the grounds that the trustee abused its discretion.

For a complete discussion of the appropriate words to use in a trust to grant complete discretion to the trustee, see Clifton B. Kruse, Jr., *Third-Party and Self-Created Trusts, Planning for the Elderly and Disabled Client* (3rd ed. 2002) (published by the Section of Real Property, Probate and Trust Law of the American Bar Association).

4. **Broad Investment Powers:** The trustee should be granted broad authority to invest the trust assets in items the trustee believes are in the beneficiary’s best interest, while keeping the over-arching fiduciary rules in place. For example, the trustee should be granted the authority to invest the trust estate in non-income producing assets, such as a house or condominium, an automobile, and anything else the trustee believes is appropriate for the beneficiary but where the trust maintains ownership. Also, the trustee should be granted discretion to charge the beneficiary for the use of the item, or allow the beneficiary to use it for no charge.

To illustrate this, consider the situation where the trust purchases and retains ownership of a house where the beneficiary resides. The trustee should have total discretion to either charge rent or allow the beneficiary to live rent free. And if the trustee charges rent, the

trustee should be allowed to determine the amount of that rent without taking into account what fair market rent would normally be for such a dwelling. A sample of a trust provision that accomplishes this is set forth below

“Non-Income Producing Assets: The Trustee may buy, sell and invest in non-income producing assets, tangible personal property, and housing owned solely by the Trust, or solely by or jointly with another person, including a beneficiary of the Trust. The Trustee, in the Trustee's sole and absolute discretion, may allow any beneficiary, and appropriate companions of a beneficiary, to live in any such housing on a rent-free basis, or the Trustee may charge rent of any amount, and without liability, deem such rent to be reasonable. The Trustee is authorized, but not required, to pay all costs of such housing, including, but not limited to, all taxes, assessments, maintenance, repairs and operational costs, such as domestic and/or custodial assistance.”

5. Limit the Trustee’s Powers: Some powers often granted to the trustee in the standard provisions of most trusts should be removed or altered. For example, most trusts grant the trustee authority to terminate a trust early if the corpus of the trust becomes so small that it is no longer economically feasible for the trustee to continue to operate the trust. Some of these clauses will even set a dollar minimum, such as \$50,000 or \$100,000, and state that the trustee can terminate the trust if the corpus gets this small. Most of these clauses say the any trust assets remaining upon termination of the trust should be distributed outright to the current income beneficiary, although there may be a holdback clause elsewhere in the trust that allow the trustee to distribute this to a third-party for the beneficiary’s benefit. Termination clauses such as this should be eliminated from a special needs trust.

SSI and Medicaid in most states have a \$2,000 limit on the amount of non-exempt resources the beneficiary can have and still maintain eligibility for the program. Any distribution above this will have the effect of disqualifying the beneficiary from these programs. Also, any distribution directly to the beneficiary will be deemed to be “income” by these programs and may also cause a reduction or elimination of the beneficiary’s benefits. If a termination clause is desired, it should be contained in a separate clause that takes these limitations into account. This is discussed later in these materials.

6. **Limit the Beneficiary’s Powers:** Care should be taken to limit the powers granted to the beneficiary. If the beneficiary has too much control over the trustee or the trust corpus, there is a risk that the trust estate may be deemed to be an available resource to the beneficiary and cause disqualification from the need based public assistance programs. Exactly how strictly the beneficiary’s powers need to be restricted will vary by state. Each state has its own unique statutes, regulations, case law precedent and interpretations made by its Medicaid agency. However, some of the restrictions to consider are set forth below.

a. **Power to Remove and Replace the Trustee:** The power to both remove and replace a trustee, or sometimes the power to do either of these, may be interpreted as granting the beneficiary de facto control over the trust and cause the trust estate to be deemed to be an available resource to the beneficiary. If this is how the state’s law that will be used to interpret the trust would view these powers, then they should be granted to someone other than the beneficiary.

b. **Power to Demand a Distribution from the Trust:** The beneficiary must not have the ability to require the trustee to make any distribution from the trust. If so, whatever the trustee could be forced to distribute will be deemed to be an available resource to the beneficiary for Medicaid and SSI eligibility purposes. A standard spendthrift clause should always be in a special needs trust. An example is:

Spendthrift Provisions: This is a spendthrift trust. None of the trust estate, income or principal, is available to the beneficiary except in the Trustee's sole and absolute discretion, and then only to the extent that other resources are not available to adequately provide for the beneficiary. No interest in the principal or income of this Trust shall be anticipated, assigned, or encumbered, or shall be subject to any creditor claims or to any legal process prior to its actual receipt by the beneficiary. Furthermore, because this Trust is to be conserved and maintained for the supplemental needs of the beneficiary throughout the beneficiary's life, no part of the corpus of this Trust, neither principal nor undistributed income, shall be construed as part of the beneficiary's estate or be subject to the claims (whether during the beneficiary's life or after the beneficiary's death) of voluntary or involuntary creditors for the provision of necessities, care and/or services, including residential or institutional care by any public entity, office, department or agency of any state or the United States or any governmental, private or charitable agency. Under no circumstances can the beneficiary compel a distribution from this Trust for any purpose."

B. Clauses to Consider Using in a Special Needs Trust: In addition to the clauses that are required in a special needs trust, there are others that should be strongly considered. In your author's experience, most of these are always included in a special needs trust, but since they are not required in order to make a trust a special needs trust, they are described in this section of the materials.

1. Oversight of the Trustee: As with any trust, someone or some entity should have the authority and responsibility to oversee what the trustee is doing with the trust estate. This starts with requiring the trustee to keep accurate books and records and provide accountings

at least annually. The questions become to whom does the trustee provide those accountings and who has access to the trust records and authority to inspect and question what the trustee is doing?

With a traditional support trust, such oversight is usually granted to the current income beneficiary. With a special needs trust this may be appropriate if the beneficiary has only a physical disability and is mentally capable of being responsible for such oversight. However, if the beneficiary's disability affects his or her mental abilities, then the beneficiary may not have the capacity to review or understand the trustee's records and accountings. In such event, this responsibility should be given to someone else.

Options to consider are the beneficiary's guardian, a trust protector, a named person, a personal agent, or a court. These are discussed below.

- a. **Guardian:** If a guardian has been appointed by a court to make personal decisions on behalf of the beneficiary, this is the logical person to be responsible for overseeing the actions of the trustee of the special needs trust. The guardian will have been charged by the court to watch over the beneficiary and make medical and legal decisions on the beneficiary's behalf. As such, the guardian should be kept informed about the status of the trust. Therefore, it is often appropriate for the trust to grant oversight of the trustee to the beneficiary's guardian.

However, occasionally the settlor of the trust does not like or trust the guardian and does not want the guardian to have any oversight of the trustee or authority over the trust. This may occur, for example, when the guardian is an ex-spouse of the settlor and the beneficiary is their child. In this event, the settlor will want to specifically restrict what is disclosed to the guardian and, instead, grant someone else oversight of the trustee.

b. **Trust Protector:** The concept of a trust protector is a topic that is worthy of an entire presentation or book all by itself, so these materials will, of necessity, be extremely limited. However, a review of some of the major options to consider when designing the responsibilities of a trust protector are mentioned below.

At its core, a trust protector is charged with “protecting” the trust and/or the beneficiary and what the beneficiary receives from the trust. The powers granted to a trust protector can be broad or limited, depending on what the settlor wants to accomplish. There are a vast array of options available when designing a trust protector for a special needs trust.

A trust protector can be single person, two people acting together or a committee of people. If a committee, it can be made up of specifically named people or categories of people. For example, a committee could be made up of the person who is serving from time to time as the beneficiary’s guardian, caseworker (either provided by a state agency or privately employed by the trust), CPA, financial advisor, lawyer and a person related to the beneficiary by blood. However the original trust protector or committee members are chosen, there should be some mechanism for successor trust protectors. This can be accomplished by the settlor naming a succession of people or allowing the current trust protector (or committee) to appoint a successor. In states that allow microboards, a microboard can be established and named as a trust protector.

The powers granted to the trust protector can be limited or vast. Examples of some powers that can be granted, either alone or combined, include the power to guide, advise or direct the trustee in making distribution or investment decisions, to review the trustee’s books, records and annual accountings, to challenge and question anything found in such records or accountings, to remove a trustee, to select a

replacement trustee (either limited to a corporate trustee, a non-profit agency that serves as trustee of special needs trusts and/or a person), to amend the trust (either limited to changes required to keep the trust exempt for Medicaid and SSI purposes, or to change trustee powers or other similar provisions, or to change how the trust estate is distributed to successor beneficiaries, or to even change the successor beneficiaries of the trust, and so on), and to terminate the trust. How much power is granted to a trust protector depends on what the settlor wants to accomplish and protect against.

No matter how the trust protector is designed (individual or committee) and what powers are granted, the trust also should clarify whether the trust protector has the responsibility to initiate such oversight, or merely wait until someone or some action triggers the starting of the trust protector's responsibilities. Also, it is important to clarify whether the trust protector is a fiduciary for all, some or none of the actions to be taken. A recent Missouri Court of Appeals case has focused on this issue. See *Robert T. McLean Irrevocable Trust v. Davis* (Mo. Ct. App., No. SD28613, Jan. 26, 2009). Although your author makes no claims of viability, consider the effect of the following clause concerning this issue:

“Although any action the Trust Protector takes on behalf of a beneficiary or this Trust is to be in the best interest of the beneficiary, the Trust Protector is not responsible for monitoring the Trustee's actions or the condition of the beneficiary unless asked to do so by the beneficiary or an interested person. This is not to imply that the Trust Protector cannot take such actions on his or her own initiative or in any way limit the Trust Protector's authority to do so. The purpose of this Section is to clarify that the Trust Protector does not have a fiduciary duty to initiate such actions or to supervise anything the

Trustee does on behalf of the Trust or the beneficiary, including, but not limited to, the trust investments or distributions made by the Trustee. However, if the Trust Protector is asked to fulfill any of the jobs to be performed by the Trust Protector as set forth in this instrument, or actually begins to do so on his or her own initiative, then the Trust Protector shall, beginning at that time and only for that particular job, have a fiduciary duty to perform such job to the best of his or her ability and in the best interest of the beneficiary. However, taking a particular action shall not cause a fiduciary duty to be imposed on the Trust Protector for any other potential actions, jobs or responsibilities that may be undertaken by or imposed on the Trust Protector.”

c. **Personal Agent:** If a trust protector is not appointed, but oversight of the trustee is still desired, consider utilizing the concept of a personal agent. This is a person who can be given most of the same authority as a trust protector, but the person who actually serves in this role is determined by a position held, not by name. For example, the first personal agent can be the beneficiary’s guardian, if one is appointed. If not, the second person to fill the role of personal agent can be the beneficiary’s conservator (guardian of the beneficiary’s property) if one is appointed. If not, it can then be the agent appointed in the beneficiary’s durable power of attorney (if the drafter of the trust wants the beneficiary to have this much input into who the personal agent is), or a majority of the siblings of the beneficiary, and so on. At the end of the list, if no one else can or will fill the role, is a court of competent jurisdiction. An example of a clause that appoints a personal agent is below:

“Personal Agent: As used in this Trust, the term "Personal Agent" shall mean the following, successively in the order named. If a

person is serving as Personal Agent under the first category (as the guardian of the beneficiary) then none of the persons described in the succeeding categories shall have the authority to or serve as Personal Agent. If there is no guardian appointed for the beneficiary, then the person in the second category (a conservator) shall be the Personal Agent and none of the persons in the succeeding categories shall have the authority to serve as a Personal Agent. This pattern shall continue on down the list in order of priority.

Subject to the above description, the categories of persons who can serve as a Personal Agent for a beneficiary shall be the following:

- (i) the court-appointed guardian of the beneficiary;
- (ii) the court-appointed conservator of the estate of the beneficiary;
- (iii) a person designated in writing by either parent of the beneficiary, or the survivor;
- (iv) a majority of the siblings of the beneficiary, or the survivor;
- (v) a person appointed as the beneficiary's attorney-in-fact under a duly executed and valid Durable Power of Attorney;
- (vi) the spouse of the beneficiary (if the spouse and the beneficiary are then living together and are not in the process of separating or divorcing); or
- (vii) a court of competent jurisdiction.”

2. **Trust Advisor:** It is often important that there is someone closely associated with the beneficiary who is familiar with the beneficiary's needs and desires who has input concerning how and when distributions are made from the trust for the benefit of the beneficiary. If a family member or close family friend is serving as trustee, then this person may have sufficient contact with the beneficiary to accomplish this. However, the further removed the trustee is from the beneficiary, and especially if the trustee is a corporate trustee, the more important it becomes to have someone appointed as an advisor to the trustee. If a trust protector is appointed by the trust, the trust protector may fill this role. The following is one way to design this provision.

"Bam Bam's Trust Advisor: In the event that neither of the original Trustees are serving as Trustees of this Trust, it is Settlor's desire that Fred Flintstone, Wilma Flintstone and Barney Rubble, successively in the order named, serve as an advocate for Bam Bam's interests and advisor to the Trustee with authority to counsel with or guide the Trustee concerning decisions about distributions for the benefit of Bam Bam. As such, Fred Flintstone, or his successor, is referred to in this document as the "Trust Advisor." The Trust Advisor shall have the authority to guide and advise the Trustee concerning administration of this Trust and distributions to or for the benefit of Bam Bam. However, the Trust Advisor shall not have the authority to override any decision of the Trustee regarding distributions for Bam Bam's benefit. It is Settlor's desire that the Trust Advisor meet with Bam Bam as often as needed and the reasonable expenses incurred for such meetings shall be paid by the Trustee of Bam Bam's trust. Fred Flintstone, at any time, otherwise the last serving Trust Advisor, shall have the power to appoint a successor Trust Advisor to replace any Trust Advisor who resigns, dies or becomes incapacitated. A Trust Advisor shall not be entitled a fee for his or her services, but shall be entitled to reimbursement of any reasonable

expenses that may be incurred on behalf of the Trust. A Trust Advisor does not have to accept such reimbursement. A Trust Advisor that has previously waived reimbursement may change her mind and begin to receive reimbursement at any time.”

3. Power to Amend the Trust: It is not unusual for a special needs trust to need to be amended at some time during its existence. This can occur, for example, if the beneficiary moves to another state and the new state’s Medicaid agency requires that a provision of the trust be changed, added or removed before that agency will treat the trust as exempt for Medicaid eligibility purposes. If the trust does not have a provision authorizing someone to amend the trust, then it will usually become necessary to go to court to accomplish this. If the trust was established by court action, as sometimes happens with self-settled special needs trusts or always happens with third party-settled testamentary trusts, then the court may have required that any future amendment be approved by the court. However, in many cases, if the trust contains appropriate authority, it is not necessary to go to court to amend a trust.

If a trust protector is appointed by the trust, then usually the trust protector is granted the authority to amend a trust. If a trust protector is not used, then often the trustee is granted such authority. Unless the special needs trust is a revocable trust and the settlor is still living, the settlor normally would not have the authority to amend the trust.

At a minimum, the amendments allowed without court action should be the ability to amend the trust to comply with law changes or interpretations that otherwise will cause the trust to be an available resource for Medicaid or SSI eligibility purposes. As discussed earlier in these materials, a trust protector can also be granted vast authority to amend the trust to comply with changing circumstances, even to the point of changing successor beneficiaries.

As an example of authorizing a trustee limited authority to amend a trust, consider the following:

“Limited Power of Trustee to Amend: Notwithstanding contrary provisions of this Trust, the Trustee shall have the power, by an instrument in writing filed with the Trust records, to alter or amend any provisions of this Trust Agreement to: (1) facilitate the administration of this Trust; and (2) accommodate changes in the tax or any other laws relating to or affecting this Trust; and (3) make changes that are recommended, or required, to allow the beneficiary to qualify, or continue to qualify, for public benefits and services of any kind in any jurisdiction, including but not limited to benefits under the Medical Assistance Program (Medicaid), 42 U.S.C. §1396 and its successors. The decision to amend or not amend this Trust shall be made by the Trustee in its sole and absolute discretion, either on its own motion or on the motion of any beneficiary (or such incapacitated beneficiary's Personal Agent) who is then presently eligible to receive distributions from the Trust; provided, however, that no contingent beneficiary not presently vested in the trust estate, nor any government or private agency, shall have standing to petition the Trustee or any court to alter or amend this Trust. To the extent possible, amendments should conform with the purposes of this Trust and with any regulations that are approved by any governing body or agency relating to 42 U.S.C. §1396, or related statutes, including state statutes that are consistent with the provisions and purposes of this Trust.”

4. **Early Termination of the Trust:** A special needs trust can contain a clause that allows the trustee (or a trust protector) to terminate the trust even though the beneficiary is still living. This can be because the trust corpus is too small, or because the trust has been deemed to be an available resource by a public benefit agency and the trustee does not want to further challenge that decision, or because circumstances have changed, such as the beneficiary no longer has a disability. Some attorneys designing a special needs trust include such a clause as a “poison pill” to discourage an agency from challenging the trust - even if

the agency wins and the trust is deemed to be an available resource, the trustee can terminate the trust and pay the proceeds to another person (usually the successor beneficiary) so the primary beneficiary will still maintain eligibility for the public assistance program. Usually, if such a clause is included in a special needs trust, there is a provision requesting that the people who receive the trust estate upon such early termination voluntarily use such assets for the supplemental needs of the original trust beneficiary. A sample clause is below.

Termination of Trust by Trustee: Notwithstanding any other provision of this Trust Agreement, if the Trustee, in its sole discretion, determines that continuation of this entire Trust or any share or trust created by the provisions of this Trust Agreement are contrary to the best interest of the beneficiaries of such trust by reason of (1) legislation, or government agency or court rulings, or (2) unforeseen changes or circumstances, or (3) because the value of the trust's or separate share's assets are at such a level, in the sole judgment of the Trustee, as to make continued administration of it financially burdensome and uneconomical, then the Trustee, in its sole discretion, may at any time terminate any such trust estate, share or merged trust estate and distribute the principal of it, together with undistributed income, free from trust, to the person(s) then entitled to receive the income, subject to the holdback provisions contained in this Trust; provided, however, that no such distribution shall be made to [name of the primary beneficiary], but on the contrary, shall be made to the beneficiaries of the Trust as if [name of the primary beneficiary] was not living, as described above. For all beneficiaries other than [name of the primary beneficiary], if there are not then any income beneficiaries, then such sums shall be distributed to the then current remainder beneficiaries of such trust estate, in the same percentages as they are named beneficiaries of such trust estate. Despite the above provisions, no Trustee who is also a beneficiary of any trust shall have nor may exercise

such power to terminate a trust. This power shall only be exercised by the other Trustee, Trustees or a Special Trustee that is “independent” (as defined by Internal Revenue Code §672), if any, and if none, this power shall not be exercisable except by a court of law.”

If the trust is a third party-settled trust, then an early termination clause should be able to be used without any problems from the Medicaid or SSI programs. However, if the trust is a self-settled special needs trust, whether a d4A or pooled trust, and particularly if the beneficiary is receiving SSI, then a recently issued POMS must be taken into consideration. POMS SI 01120.199 imposes three requirements on all self-settled special needs trusts that contain an early termination clause. As a result of this POMS, the trust estate will be deemed to be an available resource for SSI eligibility purposes if the early termination clause does not meet the following three requirements:

- The State must receive all amounts remaining in the trust upon early termination up to the amount of total Medicaid assistance paid by the State on behalf of the trust beneficiary,
- After the State is reimbursed, all remaining trust assets must be distributed to the trust beneficiary (not a third person), and
- The power to terminate the trust early cannot be held by the trust beneficiary.

Although this only applies to beneficiaries who are receiving SSI, it is anticipated that many states will adopt this rule for Medicaid eligibility purposes.

5. IRA Paying to a Special Needs Trust: If it is possible that the special needs trust may receive retirement plan proceeds such as an IRA, then care must be taken in

designing and drafting the trust. This is a topic that is extremely complex and easily requires many presentations or its own book to fully explain. As a result, the details are beyond the scope of these materials. However, be assured that it is possible to name a special needs trust as a beneficiary of an IRA and stretch the IRA payments over the life expectancy of the special needs trust beneficiary if the trust is properly designed. This is true whether the special needs trust is self-settled or third party-settled.

Briefly, some of the items for the attorney drafting the trust to take into account are: the special needs trust must qualify as a Designated Beneficiary. If the special needs trust is a third party-settled trust it should be an accumulation trust. Although much easier to design and draft, a conduit trust should not be used for a special needs trust because distributing the IRA Minimum Required Distributions each year to the beneficiary will cause the beneficiary to have “income” which will usually have adverse consequences for the beneficiary’s eligibility for Medicaid and SSI. Instead, the special needs trust should be an accumulation trust. This means the beneficiaries who will receive the trust estate after the current beneficiary dies must be taken into account when determining the length of time the IRA distributions can be “stretched.”

If a person who has a disability is named directly as the beneficiary of an IRA, look at PLR 200620025. In this private letter ruling the IRS ruled that an IRA transferred into a d4A trust was not deemed to be a transfer for income or gift tax purposes and that the beneficiary’s life expectancy could be used to determine the length of the distribution of the IRA. In other words, the IRA could be stretched over the beneficiary’s life expectancy. This occurred because the trust was a grantor trust for income tax purposes.

IV. HOW TO ESTABLISH A THIRD PARTY-SETTLED SPECIAL NEEDS TRUST

Any third party-settled trust can be established by using a last will and testament (a testamentary trust) or by using a living trust (sometimes referred to as an inter vivos trust). If a living trust, it can

be standalone or a section of a living trust that also contains provisions for other beneficiaries. Also, a living trust can be revocable or irrevocable. There is no right answer for every special needs trust; which option is chosen will depend on the circumstances and the settlor's desires. This section of these materials will summarize some of the advantages and disadvantages of these various choices.

A. Testamentary Trust: The language that describes and establishes a third party-settled special needs trust can be placed in a person's last will and testament. If so, then upon the testator's death the will can be admitted to probate and the court can order the establishment and funding of the special needs trust at anytime during the probate proceedings or, at the latest, at the end of the proceedings.

Whether a person chooses to establish a special needs trust in this manner will depend on whether the person wants his or her estate to go through probate. If so, then a will should be used as the primary estate planning document. However, if the person wants to avoid probate upon death, then a living trust should be used as the primary estate planning document rather than a will. The one exception to this is if a person wants to establish a special needs trust for his surviving spouse. If so, then a will must be used or the trust will be deemed to be an available resource to the surviving spouse. See 42 U.S.C. §1396p(d)(2)(A).

B. Living Trust: If a person chooses to use a living trust to establish a special needs trust, then there are various design options to consider.

1. Standalone Special Needs Trust or Section in Main Living Trust: Should the language that establishes the special needs trust be placed inside the settlor's primary living trust or in a separate standalone living trust? The settlor's primary living trust contains all of the provisions describing how the estate will split and distribute upon the settlor's death, one portion of which will be retained in a special needs trust for the beneficiary who as a disability. A separate standalone living trust only contains special needs provisions for the

beneficiary and usually is titled with the beneficiary's name (for example, the "John Doe Special Needs Trust" if John Doe was the person who has the disability and is the primary beneficiary of the trust).

a. **Advantages of a Standalone Special Needs Trust:** There are many advantages to utilizing a standalone living trust for the special needs trust. Some of them are:

1) It may be easier to get the trust approved by the agency who reviews the trust to determine whether it is an exempt trust for public benefit eligibility purposes. When the settlor dies and money is set aside in a special needs trust for the beneficiary who is receiving public assistance, this must be disclosed to the agency overseeing the program. Normally that agency will want to review a copy of the trust to make a determination whether the trust assets are exempt or count as an available resource for eligibility purposes. If the trust is a separate standalone trust that is only for the benefit of the beneficiary it is usually easier for the agency to review and approve the trust than if the trust is buried inside a much larger trust that contains provisions for many beneficiaries. Also, there may be provisions in the larger trust that, if applied to the special needs trust, would cause the special needs trust to be an available resource. It is not unusual for a state employee reviewing the trust to decide that the disqualifying provisions also apply to the special needs portion of the trust and rule that the trust disqualifies the beneficiary from the program. Although this may be overcome on appeal, that takes more time and potentially costs the trust more in attorney's fees. All of this may have been avoided if the trust was a standalone trust.

2) Other people can name the standalone special needs trust as a beneficiary of their estate plan, or can make lifetime gifts to the trust for the benefit of the beneficiary who has a disability. For example, if a parent establishes a standalone special needs trust for the benefit of her child, then the grandparents or aunts and uncles can name that trust as a beneficiary in their own estate plans and leave money for the benefit of the child who has a disability without having to establish, and pay for establishing, a special needs trust themselves. The donor needs to be aware that if the standalone special needs trust is a revocable trust and the settlor is still living, then such a gift is actually a gift to the settlor for asset protection and income, gift and estate tax purposes. If the donor is not comfortable with this, then the trust can be amended by the settlor into an irrevocable trust, or the donor can choose to not give anything to the trust.

3) It is easier to set aside assets for the beneficiary of the special needs trust in addition to a share of the settlor's estate. For example, sometimes a parent will hold assets that are earmarked for the child who has a disability and want that child to have these assets in addition to his or her share of the parent's estate upon the parent's death. This may occur because someone gave the parent money or assets to hold for the child who has the disability because such a gift would have caused the child to be disqualified from Medicaid or SSI. Or sometimes parents who charge their child for room and board so the child will receive full SSI save the money and view it as the child's money, not the parent's. They want this money to be allocated to that child's share of the estate so the parent's other children do not share it when the parent dies. Traditionally the parent would keep these assets in a separate account and would specifically identify that account to be allocated to the special needs trust upon the parent's death. This meant if the account is ever

changed, the estate plan document had to be amended to identify the new account. If, on the other hand, a standalone special needs trust is used, the parent merely has to open an account in the name of the special needs trust and transfer the money into that account. If the trust is revocable, the parent's Social Security number is the tax identification number of the trust and all income is taxable to the parent. If the trust is irrevocable, it will have its own tax identification number. Also, if it is irrevocable, there may be gift tax consequences when the parent transfers the money into the account in the name of the trust.

b. Disadvantages of a Standalone Special Needs Trust: It will most likely cost more in attorney fees to draft a standalone special needs trust than merely add a section inside the settlor's primary living trust. It also may seem more complicated to the settlor to have more than one trust.

c. Advantages of Special Needs Trust Inside Main Living Trust: The primary advantage of placing the special needs trust language inside the settlor's main living trust is that it may be less expensive to draft. Also, this may be preferred if the distribution to a beneficiary who has a disability is contingent on other people not surviving the settlor, or if it is quite likely that the beneficiary may not survive the settlor.

d. Disadvantages of Special Needs Trust Inside Main Living Trust: The disadvantages of placing the language to create a special needs trust inside the settlor's main living trust are the opposite of the advantages to using a standalone special needs trust. See above.

2. **Revocable or Irrevocable Standalone Special Needs Trust:** If a standalone special needs trust is used, then it must be decided whether the trust is to be revocable or irrevocable. There are advantages and disadvantages to each option.

a. **Advantages of Revocable Standalone Special Needs Trust:** If a standalone special needs trust is revocable, then the settlor can change any provisions of the trust at any time. This allows the settlor to adapt the trust as circumstances change. Also, since the trust is revocable, the settlor is the grantor of the trust for tax purposes. This means that there are no gift tax issues if the settlor transfers assets to the trust and no separate income tax return required for the trust as long as the settlor is living; all trust income is included on the settlor's personal income tax return. Also, since the assets are included in the settlor's estate for estate tax purposes, if there is an estate tax in effect when the settlor dies there will be an automatic step-up in basis for capital gain purposes. Even if there is not an estate tax law in effect, the assets in the trust will still be eligible for increased basis to be allocated to it by the settlor's executor.

b. **Disadvantages of Revocable Standalone Special Needs Trust:** Upon the death of the settlor, the assets in the trust are included in the settlor's estate for estate tax purposes. This may cause an estate tax to be payable if the settlor's estate is large enough and there is an estate tax imposed when the settlor dies. Also, the assets in the trust are subject to the claims of the settlor's creditors. In addition, it may be a disadvantage that the income earned on the assets held in the trust is taxed to the settlor. Any gifts made to the trust from others are actually gifts to the settlor for tax and liability purposes. Any distribution from the trust to or for the benefit of the beneficiary is deemed to be a gift from the settlor. This may cause gift tax issues for the settlor.

c. **Advantages of Irrevocable Standalone Special Needs Trust:** Assets held in the trust are not included in the settlor's estate for estate tax purposes, and income earned on trust assets is not taxed to the settlor. The assets in the trust are free from the claims of the settlor's creditors. Other people can make a gift to the trust and it will not be something the settlor can use for the settlor's personal benefit, nor will it be subject to the settlor's creditors. Gifts from the trust to or for the benefit of the beneficiary are not deemed to have been made by the settlor.

d. **Disadvantages of Irrevocable Standalone Special Needs Trust:**

Since an irrevocable standalone special needs trust is not a grantor trust for tax purposes (although it is possible to design such a trust to make it a grantor trust), the trustee will need to prepare and file a separate 1041 income tax return for the trust. Income tax brackets are compressed for irrevocable trusts, so it is possible that the trust will pay more tax on the same amount of income than would be paid if the income was taxed to the settlor. However, any distributions from the trust are deemed to have been first from income, so spending money on behalf of the beneficiary will pass the income tax liability out to the beneficiary. The settlor can not amend or change the trust to adapt to changing circumstances (although such authority can be granted to the trustee or a trust protector when the trust is established). Lifetime transfers to the trust from anyone, including the settlor, will be a taxable gift for gift tax purposes. The gift will not qualify as a present interest gift (and become eligible for the annual gift tax exclusion, which is currently \$13,000/person/year) unless Crummey withdrawal powers are granted to a beneficiary. See *Crummey v. Commissioner*, 397 F.2d 82, 88 (9th Cir. 1968). Withdrawal powers cannot be granted to the beneficiary who has a disability without causing eligibility issues for SSI and Medicaid. Most commentators believe it is possible to grant withdrawal powers to other beneficiaries of the trust (see *Estate of*

Cristofani v. Commissioner, 97 T.C. 74 (29 July 1991)), but extreme care must be taken in designing such a trust.

V. CONCLUSION

These materials are intended to provide an overview of the unique provisions that need to be included or considered when designing a special needs trust. Many of the details of the topics mentioned in these materials are merely summarized and are current as of the date these materials are prepared. The reader is cautioned to carefully review the exact details of any design strategy chosen, confirm the unique rules governing trusts and Medicaid eligibility for the state where the beneficiary resides, and update all research before drafting a special needs trust.