

TERMINATING SPECIAL NEEDS TRUSTS

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Special needs trusts may end upon the death of the beneficiary, the exhaustion of principal, or the occurrence of an event. Termination of a special needs trust during the lifetime of the beneficiary with disabilities (“early termination”) may be desirable because that beneficiary may no longer be eligible for means-tested public benefits such as Supplemental Security Income (“SSI”) or Medicaid. This paper will address early termination and termination upon the beneficiary’s death in the context of self-settled special needs trusts and third-party special needs trusts.

Self-Settled Special Needs Trust

A self-settled special needs trust (often referred to as a first-party SNT, OBRA ’93 trust or (d)(4)(A) trust) is a trust funded with assets owned by a beneficiary. 42 U.S.C. § 1396p(d)(4)(A) sets forth the federal statutory authority for self-settled special needs trusts. Such trusts (i) must be established by a competent individual with disabilities, or a parent, grandparent, guardian, or the court for the sole benefit of the beneficiary, (ii) the beneficiary must be under the age of 65 when the trust is established and funded, (iii) the beneficiary must be disabled as defined under Social Security law, and (iv) the state must “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 title [42 U.S.C. §1396 et seq.]”

The Medicaid statutes and regulations of various states contain similar provisions. For example, New Jersey’s regulation, N.J.A.C. 10.71-4.11(g)(1)(xii) provides:

The trust shall specifically state that, upon the death of the primary beneficiary, the State will be notified, and shall be paid all amounts

in the trust up to the total value of all medical assistance paid on behalf of the beneficiary.

Pennsylvania's 55 Pa Code §178.7 states that:

The Commonwealth will receive the amounts remaining in the trust upon the death of the individual, up to an amount equal to the total of MA benefits paid on behalf of the individual.

Illinois' state law, 89 Ill. Admin Code, Ch. 1, Sect. 120.347(d)(1) states:

Any amount remaining in the trust (up to the amount expended by the Department on medical assistance) shall be paid to the Department upon the death of the person.

These state regulations expressly authorize payback upon the death of the beneficiary, yet are silent on the issue of early trust termination.

On the other hand, Arizona and Colorado have statutes that require reimbursement to the state from assets remaining in a self-settled special needs trust that is terminated prior to as well as upon the death of the beneficiary:

Arizona - A.R.S. § 36-2934.01 states that the trust must have:

Specific language that protects the state's beneficiary interest in the trust and that names the administration or the state Medicaid agency as the primary beneficiary of the trust if the trust is terminated before or on the death of the member.

Colorado – C.R.S. § 15-14-412.8 states:

The trust provides that, upon the death of the beneficiary or termination of the trust during the beneficiary's lifetime, whichever occurs sooner, the department of health care policy and financing receives any amount remaining in the trust up to the total medical assistance paid on behalf of the individual.

Early termination provisions in self-settled special needs trusts cause the trusts to terminate before the death of the beneficiary. Historically, many practitioners included such provisions to avoid payback upon the death of the beneficiary by permitting the trustee to terminate the trust prior

to the death of the beneficiary. Such provisions also were useful if the beneficiary no longer qualified for or needed SSI or Medicaid, or the trust no longer contained sufficient assets to justify continued trust administration.

The Program Operations Manual System (“POMS”) is used by Social Security Administration employees as a primary source of information in processing claims for Social Security benefits.¹ The public version of the POMS can be accessed at <https://secure.ssa.gov/poms.nsf/home!readform>. Special needs planning practitioners often rely on the POMS when drafting self-settled special needs trusts.

Prior to June 25, 2010, there was some confusion as to whether early termination provisions caused the assets in a self-settled special needs trust to be countable. If the trust could be terminated during the lifetime of the beneficiary and the trust assets were distributed to a third party, then the trust could be considered to violate the “sole benefit” requirement of 42 U.S.C. § 1396(d)(4)(A). Moreover, if the assets could be distributed to the beneficiary, then the beneficiary could be considered at some point to be in a position to control the assets, thus rendering the trust corpus countable for SSI purposes. *See* POMS SI 01120.200 D 2; *see also*, 20 C.F.R. § 416.1201(a)v; *Kemble v. Barnhart*, 964 Soc. Sec. Rep. Service 639 (N.D. Ill. May 10, 2004).

On June 25, 2010, the Social Security Administration issued new clarifications in the POMS at SI 01120.199 with respect to early termination provisions in self-settled special needs trusts created on or after January 1, 2000 but stated that these instructions were to become effective October 1, 2010. These clarifications set forth the criteria the Social Security Administration

¹ The POMS is an internal handbook which has no legal force and is not binding on the Secretary of the Social Security Administration. *See Schweiker v. Hansen*, 450 U.S. 785,789 (1981). As a practical matter, however, it dictates the treatment of trusts by the Social Security Administration in the absence of conflicting statutes, regulations and rulings. *See* <https://secure.ssa.gov/poms.nsf/home!readform>.

employees will use to determine the countability of special needs trusts with an early termination provision.²

SI 1120.199 exempts a special needs trust which contains an early termination provision when: (a) the state is the primary assignee, (b) the state receives all amounts remaining in the trust at the trust termination, after the payment of reasonable fees and allowable expenses³, up to the total amount of benefits paid on behalf of the beneficiary, (c) the trust is for the sole benefit of the beneficiary and does not allow any other entity or person to benefit from the early termination, and (d) the trust gives the power to terminate the trust to someone other than the trust beneficiary. SI 01120.199 applies to newly formed trusts and trusts previously exempted from resource counting provided that such trusts are amended within 90 days of notice to do so. This provision does not apply to third-party special needs trust, discussed below.

After the payment of expenses as set forth in SI 1120.203(B)(3) and reimbursement to the state, the remaining trust balance may be disbursed to the beneficiary. The trust may not be disbursed to the beneficiary's heirs or any other designated residual beneficiary as the trust's early termination may not benefit any person other than the beneficiary. A provision that appoints the right to receive the remaining balance to another party or entity will render the special needs trust a countable asset as such a trust is not structured for the sole benefit of the disabled trust beneficiary.

In 2010, the United States District Court addressed an early termination issue in *Hoskins v. Astrue*, Case No. 09 C 6098, 2010 U.S. Dist. LEXIS 115926. In *Hoskins*, the applicant, Robert Hoskins, suffered from cerebral palsy and received a \$500,000 personal injury award. One month prior to applying for SSI, his mother and guardian established a self-settled special needs trust for

² SI 01120.199 also is applicable to first-party pooled trusts.

³ SI 1120.203(B)(3) defines allowable expenses as taxes due from the state or federal governments due to the early termination of the trust fund and reasonable fees and administrative expenses associated with final accountings and wrapping up the administration.

Robert's benefit and funded same with the settlement proceeds. The trust provided that it "shall terminate upon Robert's election following his restoration of rights or upon [his] death." The trust further provided that, upon Robert's death,

the Trust assets remaining ... shall be paid to the appropriate State agencies, as reimbursement to the State ... for benefits provided ... during ... lifetime, except that the Trustee may with court approval and consistent with existing law first pay any outstanding, reasonable expenses for maintaining the existence of the Trust, and final bills, debts, expenses, taxes, fees, and funeral-related items.

The Social Security Administration, and ultimately the Appeals Council, deemed the trust a countable asset (after two trust amendments to conform with 42 U.S.C. § 1396(d)(4)(A) and the POMS) as Robert could revoke/terminate the trust following his restoration of rights and the trust failed to provide the state as primary assignee. The plaintiff amended the trust a third time to conform with the above referenced statutory authority; however, the Appeals Council denied consideration of the third amendment on procedural grounds. The US District Court remanded the case to the Appeals Council for consideration of the third amended trust.

Evaluating this case in light of SI 1120.199 and SI 1120.203(b)(3), it is clear that the trust was a countable asset in its initial and secondary form as the trust provided the beneficiary with the right to terminate the trust during his lifetime and provided for the payment of funeral related expenses prior to payback. The provisions of the third trust amendment were not referenced in the opinion.

Although New Jersey's regulations are silent as to the termination of a self-settled special needs trust prior to the death of the beneficiary, the Division of Medical Assistance and Health Services of the New Jersey Department of Human Services takes the position that it would not object to the termination of an irrevocable self-settled special needs trust by the probate court upon an application on behalf of the beneficiary to terminate the trust if 1) the beneficiary formally advises

the Social Security Administration that she is no longer disabled for purposes of receiving SSI and Medicaid and 2) the State of New Jersey is repaid the amount it expended on behalf of the beneficiary. This position is regardless of whether the trust contains an early termination provision.

Do the POMS instructions pertaining to early termination apply if the beneficiary of the trust is not receiving SSI benefits but receives Medicaid benefits? Arguably, the POMS clarifications would not be applicable unless the state's statutes or regulations provide otherwise.

Many special needs planning practitioners eschewed early termination provisions in self-settled trusts before the new POMS instructions were issued. In light of these clarifications, all practitioners should consider whether they want to include early termination provisions in self-settled SNTs. If the beneficiary is receiving or could receive SSI benefits in the future, early termination provisions should track the requirements set forth in SI 01120.199 D.

Drafting Issues

State law may permit trustees of self-settled trusts to transfer assets into a first-party pooled trust established pursuant to 42 U.S.C. 1396p(d)(4)(C)⁴. This ability can be advantageous if the amount of assets in the trust is too small to justify the time and expense of continued trust administration. In those states, the trust can expressly provide that the trustee may transfer the assets into a first-party pooled trust if the amount of assets in the trust no longer justify the continuation of the trust.

⁴ 42 U.S.C. 1396p(d)(4)(C) requires a first-party pooled trust (1) to be established and managed by a non-profit association; (2) to contain separate accounts for each beneficiary of the trust, although for purposes of investment and management of the funds, the trust may pool the funds from those accounts; (3) the sub-accounts must be established solely for the benefit of the disabled individual by the individual, by a parent, grandparent, or legal guardian of the individual, or by a court; and (4) 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 must repay the state the amount remaining in the account, up to an amount equal to the total amount of medical assistance paid under Title XIX of the Social Security Act on behalf of the individual.

As noted above, upon termination of the trust, the Social Security Administration requires payment of certain taxes and reimbursement to the state before trust funds can pay funeral and burial expenses. Therefore, it is prudent for the trustee to purchase an irrevocable pre-paid funeral prior to the termination of the trust.

Following payback to the state and payment of certain taxes, the net assets can be distributed to the remainder beneficiaries in accordance with the trust instrument. The status of the beneficiary and the trust laws of the state should be considered in drafting dispositive provisions for remainder beneficiaries.

If the beneficiary is a competent adult, then dispositive provisions can include a testamentary power of appointment as well as provisions for distribution in accordance with the beneficiary's testamentary intent. If the beneficiary is mentally incapacitated, however, the beneficiary would be unable to make a will or exercise a testamentary power of appointment unless the beneficiary was restored to capacity. Therefore, the remaining assets in the trust would be distributed in accordance with the state's intestacy laws. Similarly, since a minor cannot execute a will, state law may preclude the trust from containing specific dispositive provisions. If the minor may become a competent adult, it may be prudent to include a provision for a testamentary power of appointment. Of course, such a provision must be accompanied by the execution of a will after the minor beneficiary reaches the age of majority.

Post-Death Administration

Many states have statutes, regulations or policies setting forth the procedures for notification and payment to the state. For example, New Jersey's applicable regulation states:

The trust shall specifically state that, upon the death of the primary beneficiary, the State will be notified, and shall be paid all amounts remaining in the trust up to the total value of all medical assistance paid on behalf of the beneficiary. The trust shall comply fully with this obligation under the statute to first repay the State, without

requiring the State to take any action except to establish the amount to be repaid. Repayment shall be made to the Treasurer, State of New Jersey, and shall be sent to the Division of Medical Assistance and Health Services, to the attention of the Bureau of Administrative Control, PO Box 712, Trenton, New Jersey 08625-0712, or to any successor agency.

N.J.A.C. 10:71-4.11(g)(1)xii.

The trustee should request a written statement from the state regarding the balance due and the calculation thereof to ensure that the computation is correct. Following payback to the state, the trustee must attend to the preparation and filing of tax returns, accountings and distributions in accordance with the trust instrument.

Estate Taxes

Assets in a self-settled special needs trust are includable in the estate of the beneficiary. I.R.C. §2036(a). The payback amount is deductible as a claim against the estate. As to structured settlements, if the disabled individual has the right to receive annuity payments for life and a remainder beneficiary has a right to receive payments upon the death of the beneficiary, then the present value of the annuity payments that will be made to the remainder beneficiary will be included in the estate of the deceased beneficiary. I.R.C. §2039. Unfortunately, there may be insufficient assets remaining in the trust to pay the estate tax. For this reason, it is important to consider whether the settlement should be structured to provide for potential tax liabilities. In addition, in *Estate of Davenport v. Commissioner*, TC Memo. 2006-215 (Oct. 5, 2006), the United States Tax Court ruled that a remaining term of annuities paid after the death of the beneficiary pursuant to a guarantee was includable in the estate of the beneficiary. For this reason, a commutation rider should be purchased so that estate taxes can be paid if the beneficiary dies before the guarantee period expires. Even if no estate tax is due, care should be taken to assess whether state estate or inheritance taxes will be imposed.

Third-Party Special Needs Trusts

A third-party special needs trust is a trust established and funded by someone other than the beneficiary. Such trusts may be inter vivos or testamentary and the trust beneficiary can be over age 65. There is no requirement that the trust provide a Medicaid payback provision. Moreover, the trust may benefit another beneficiary without jeopardizing the beneficiary's eligibility for benefits.

Early Termination

Early termination of a third-party special needs trust is governed by the trust document and state trust law rather than the statutory and policy authority found at 42 U.S.C. § 1396(d)(4)(A), SI 1120.199 and SI 1120.203(b)(3). Following are examples of state statutes providing for early termination of trusts:

North Carolina General Statutes § 36C-4-414(a)

After notice to the qualified beneficiaries, the trustee of a trust consisting of trust property having a total value of less than fifty thousand dollars (\$50,000) may terminate the trust if the trustee concludes that the value of the trust property is insufficient to justify the cost of administration.

Texas Pr. Code. Ann § 112.059 (a)

After notice to beneficiaries who are distributees or permissible distributees of trust income or principal or who would be distributees or permissible distributees if the interests of the distributees or the trust were to terminate and no powers of appointment were exercised, the trustee of a trust consisting of trust property having a total value of less than \$50,000 may terminate the trust if the trustee concludes after considering the purpose of the trust and the nature of the trust assets that the value of the trust property is insufficient to justify the continued cost of administration.

§412(a) of the Uniform Trust Code provides

The court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not

anticipated by the settler, modification or termination will further the purposed of the trust.

§414(a) of the Uniform Trust Code further provides

After notice to the qualified beneficiaries, the trustee of a trust consisting of a trust property having a value less than [\$50,000] may terminate the trust if the trustee concludes that the value of the trust property is insufficient to justify the cost of administration.

Termination at Death

The Social Security Act does not govern trust terminations of third-party special needs trusts. Ultimately, state trust law and the trust instrument control the manner and order of trust disbursement. The trust may name remainder beneficiaries even if the beneficiary is a minor or is mentally incapacitated.

Upon the death of the beneficiary, the trustee must file applicable tax returns, pay applicable taxes and final expenses, provide a final accounting if required, and distribute the net assets to the remainder beneficiaries. Generally, wrapping up the third-party trust will entail the same procedures that are necessary to wrap up any other type of trust.

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**SAMPLE TERMINATION LANGUAGE FOR THIRD-PARTY SPECIAL NEEDS TRUST
TERMINATION UPON DEATH**

Upon the death of the Beneficiary, the balance of principal and income remaining in this trust shall be paid over and delivered to such of Grantor's descendants, in such shares, in such manner and in such proportions, outright or in further trust, as the Beneficiary shall appoint in and by his or her Last Will and Testament by making specific reference to this power. To the extent the Beneficiary shall not have the capacity to exercise the foregoing limited power of appointment or shall fail to exercise effectively such power of appointment, then the balance of principal and income remaining in his or her trust, or the unappointed principal and income thereof, shall be paid over and distributed to the descendants then surviving of the Beneficiary, per stirpes, subject to the provisions of subparagraph (h) below. In the event there shall be no such descendants of the Beneficiary, then the same shall be paid over and distributed to the descendants then surviving of Grantor's child who is an ancestor of the Beneficiary, per stirpes, or if none, Grantor's descendants then surviving, per stirpes, subject to the provisions of subparagraph (h) below.

(h) In the event any individual entitled to a distribution under subparagraph (g) above is considered Disabled, then the share for such individual shall be held in trust for said individual and administered and distributed as provided in this Paragraph, as if such individual were a Beneficiary. In the event a grandchild of Grantor who is not Disabled and who is entitled to a distribution under subparagraph (g) above shall be under the age of thirty-five (35) years, the Trustee shall hold the share for such individual ("Beneficiary") in a separate trust as provided in Paragraph 2 below. In the event any individual who is not Disabled, other than a grandchild of Grantor, who is entitled to a distribution under subparagraph (g) above shall be under the age of twenty-one (21) years, the Trustee shall pay over and deliver such share to any guardian for such individual in whatever jurisdiction appointed, to any parent of such individual, or to a custodian for such individual under the New Jersey Uniform Transfers to Minors Act, without any bond being required, for the benefit of such individual.

TERMINATION WHERE NO LONGER ECONOMICAL TO ADMINISTER

In the event that at any time during the term of any trust hereunder, the amount of trust principal under administration shall be of a size that is no longer economical to administer or the material purpose of such trust is incapable of being fulfilled, the trust may be terminated in the discretion of

the Trustee, other than a Trustee who is a beneficiary of such trust, and, if terminated, the balance of principal remaining and accumulated income shall be paid over and delivered (i) as if the Beneficiary was deceased for the trust under Paragraph 1 hereof, or (ii) to the Beneficiary thereof for any trust under Paragraph 2 hereof. All trusts for the same beneficiary or beneficiaries under this agreement shall be aggregated for purposes of this subparagraph.