Third Party Special Needs Trusts

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Special needs planning.

Special needs planning is a niche practice area within the estate planning field that requires a comprehensive understanding of various legal disciplines, including tax, government benefits, and trusts and estates. An experienced special needs planning practitioner will not only possess knowledge of the law but also be able to offer practical advice to their clients that enhances the quality of life of individuals with disabilities and their families. Familiarity with local practices and laws is essential, as these can vary significantly from state to state.

A cornerstone of special needs planning is the use of special needs trusts ("SNTs"). This outline focuses on third party special needs trusts, also known as third party supplemental needs trusts.

One of the primary goals of special needs planning is to ensure the individual with disabilities can qualify for government benefits while maintaining access to additional assets that can cover items not provided by government programs. Special needs planning is relevant for individuals currently receiving government benefits as well as those who may need them in the future.

I. Third Party Special Needs Trusts - General.

A third party SNT is a trust that is created by and funded with assets belonging to someone other than the individual with a disability. A typical example involves parents creating a third party SNT for the benefit of their child with a disability. The parents' estate plan would typically provide that, upon their deaths, the assets allocated for the benefit of the child with a disability be placed in the third party SNT created for the child's benefit. The purpose of a third party SNT is to permit a parent, grandparent or other person to set aside assets in the trust in order to provide for the needs of the beneficiary beyond what is covered by government benefits. If the assets were left outright to the individual with disabilities, they would be disqualified for Medicaid and Supplemental Security Income ("SSI"). Even wealthier families may benefit from special needs planning depending on a number of factors, including the anticipated cost of care, the age of the person with special needs, the type of disability, day programs, the community in which they reside, and how that community is pad for (e.g. through government benefits). Moreover, there can be no assurance that a family's wealth will continue to the next generation(s), potentially increasing the need to rely on government benefits to pay for at least a portion of the care of the individual with disabilities.

Third party SNTs are not governed by federal law, although some states have statutes that address them. Third parties can generally include anyone other than the person with disabilities,

although there may be other issues to address if the beneficiary is a minor child or spouse or someone else whom the creator of the trust has an obligation to support. Prior to drafting a third party SNT, it is important to determine which means-tested government benefits the beneficiary is receiving or may receive in the future. Whether the assets in a third party SNT are considered a resource for government benefits eligibility purposes will often depend upon the terms of the trust, including the existence of a support standard, the extent of discretion given to the trustee and whether the beneficiary can compel a distribution. The settlor's intent to create an SNT should also be clearly stated in the trust instrument. Use of the words "supplement, rather than supplant government benefits" are typically good indicators of the settlor's intent. In determining whether the assets of a third party SNT have any effect on the beneficiary's eligibility for SSI, it is important to review the Social Security Administration's Program Operations Manual System ("POMS") to ensure that all requisite criteria are met so that trust assets do not disqualify the beneficiary from benefits.[1]

A third party SNT can be created by a revocable inter-vivos trust, an irrevocable inter-vivos trust, or a testamentary trust under a last will and testament. One of the many benefits of creating a third party SNT during lifetime is that other relatives can leave assets to this trust if they desire. Thus, it can serve as a vehicle to receive potential bequests from others thereby ensuring that the beneficiary's government benefits are protected. If the SNT is irrevocable, the settlor can engage in their own estate tax planning through the use of lifetime gifts to the trust. The special needs planning practitioner should be careful not to give Crummey rights of withdrawal to the beneficiary with disabilities as this may result in trust assets being considered an available resource for the beneficiary for SSI and Medicaid purposes. Moreover, the failure to exercise the right of withdrawal may be considered an uncompensated transfer resulting in a penalty period with respect to the beneficiary's eligibility for those benefits. If the SNT is revocable, it is imperative that there be a provision to convert it to an irrevocable trust upon the receipt of assets from persons other than the settlor. Without such a provision, it is unlikely that others would contribute assets to the SNT for fear that the trust could be revoked, and the assets are not used to enhance the quality of life of the beneficiary with disabilities. It should be clear that the beneficiary has no right to revoke the trust.

Another benefit of an inter-vivos trust, is it is typically easier to make changes to the trust, including replacing trustees, without the need of going through the expense and time of a court proceeding which is often required with testamentary trusts.

When drafting an SNT for a surviving spouse who is receiving, or expected to receive Medicaid benefits in the future, the SNT must be a testamentary trust created under a will. Assets contained in an inter-vivos trust created by a spouse will be considered an available resource of the surviving spouse for government benefits purposes.

A third party SNT does not have to be for the sole benefit of the individual with disabilities, whereas a first party SNT must be. Thus, it is permissible to have beneficiaries of a third party SNT who are not disabled. For families with more than one child, the assets can either be left to one "pot" trust with sprinkling provisions or to separate trusts set up for each child. There are

[1] *See:* POMS § SI 01120.200.

conflicting views as to which is the best approach. The benefit of a pot trust is that the trustee can use the money where it is determined to be most appropriate among all the children. However, this can lead to an unfair (in someone's eyes) allocation of resources depending on the circumstances. By leaving the assets in separate trusts and having one of them be a third party SNT, it is clear from the beginning how much each beneficiary was intended to receive. Caution must be noted when using a pot trust if it is being funded with tax-deferred retirement assets, as unintended tax consequences can occur.

Unlike a first party SNT, any assets remaining in the third party SNT at the time of the beneficiary's death are not subject to Medicaid payback. This makes sense since the creator of the trust has no legal obligation to use these assets to pay for the expenses of the beneficiary. Thus, they should not be subject to a Medicaid payback. A third party SNT often resembles a traditional discretionary spendthrift trust drafted to protect the trust assets for the benefit of a person who is vulnerable to exploitation or who does not manage money well. In order for a discretionary trust to meet the criteria of a special needs trust, and thus be exempt from consideration when determining financial eligibility for means-tested government benefits, the trust must limit the powers of the beneficiary, the authority of the trustee, and the trust must include a spendthrift clause.

An alternative to a third party SNT is to disinherit the person with disabilities. While this will accomplish the goal of not disqualifying the individual for government benefits, it will not further the goal of enhancing their quality of life. Alternatively, some families consider leaving the assets to a third party (perhaps a sibling) who makes a verbal commitment to assist the person with a disability. Unfortunately, this type of arrangement puts the person with disabilities at risk. The person who is entrusted with the assets could pass away prior to the death of the individual with disabilities, get divorced, get married, become disabled themself, get sued, etc. For these reasons, this option is often unsuitable for most families since it does not ensure that there will be available assets to enhance the quality of life of the individual with disabilities.

II. Taxation of Third Party Special Needs Trusts.

If a third party SNT is revocable, then all income is reported on the settlor's personal income tax return. If the trust is funded, it will not constitute a completed gift for gift tax purposes and the trust corpus will be includable in the settlor's gross estate upon their death. Upon the settlor's death, the trust becomes irrevocable. Caution should be exercised if this type of trust is to be funded from sources other than the settlor as there may be unintended estate tax consequences.

If the third party SNT is irrevocable, then the trust should qualify as either a grantor trust or qualified disability trust.

A grantor trust enables the trust's income to be reported on the settlor's personal income tax return, with the settlor typically responsible for any tax due. A third-party trust can retain its grantor trust status so long as the settlor is alive. Giving an irrevocable inter-vivos third party trust grantor trust status can be an important estate planning tool for families who want to

preserve trust assets and decrease their net worth by having the settlor pay the income taxes. For a third party SNT to qualify as a grantor trust, the practitioner must include appropriate provisions under IRC sections 671 through 677 in the trust agreement. A testamentary supplemental needs trusts cannot be considered a grantor trust as the settlor is no longer alive.

Upon the death of the grantor – and sometimes upon establishment of the trust – the third party SNT will become a separate taxable entity. Due to the compressed income tax rates for trusts, if the taxable income of the trust exceeds $15,200 in 2024 the trust income will be taxed at the highest federal marginal income tax rate of 37 percent (plus the Medicare and net investment income surtax). Whereas a single individual is not taxed at the 37 percent marginal rate until income exceeds $609,350. This can be a significant issue for SNTs since not all income is typically distributed. To address this concern, the trustee can invest trust assets in investments which do not generate taxable income subject to the highest rates and can also determine if the trust meets the criteria of a qualified disability trust ("QDisT").

A QDisT can claim an exemption in the amount of $5,000 in 2024.[2] In order for a third party SNT to qualify as a QDisT, the trust must be irrevocable for the sole benefit of the beneficiary who was under the age of 65 at the time the trust was established and that the beneficiary must have a disability as defined for purposes of SSI and SSDI programs.[3] Further, the third party SNT cannot be a grantor trust. Thus, a first party SNT would not typically qualify as a QDisT because it is usually a grantor trust. On the other hand, many third party SNTs will qualify as qualified disability trusts.

Irrevocable inter-vivos third party SNTs will not be included in the settlor's estate so long as the settlor retains no dominion or control over the trust. Thus, any contributions to the third party SNT during the settlor's life will not be included in the settlor's gross estate. As mentioned above, the special needs planning practitioner should be careful not to give Crummey rights of withdrawal to the beneficiary with disabilities as this may result in trust assets being considered an available resource for the beneficiary for SSI and Medicaid purposes. Moreover, the failure to exercise the right of withdrawal may be considered an uncompensated transfer resulting in a penalty period with respect to the beneficiary's eligibility for those benefits.

III. Drafting Considerations.

A. Trustee Selection.

The selection of the trustee is one of the most, if not the most, important decisions in determining whether the special needs plan created will ultimately work for the client and their family. The perfect trustee should be knowledgeable in many areas, including trust law, tax law, government benefits law (sometimes referred to as public benefits), investments, medical issues, education issues and advocacy issues. Obviously finding the perfect trustee is not always possible. This is an area where the input of an experienced special needs trust practitioner can be extremely useful to the client.

[2] IRC § 642(b)(2)(C).
[3] 42 U.S.C. § 1396p(c)(2)(B)(iv).

The trustee may be a family member, professional colleague or a corporate fiduciary. The beneficiary themselves should not be the trustee. The government would likely argue that this would give the beneficiary too much control over the trust assets, and it could cause the trust assets to be considered an "available" resource for Medicaid and SSI purposes. It may make sense for the client to consider appointing co-trustees: a family member and a professional trustee. The family member trustee can deal with the advocacy and care issues, while the professional trustee can take care of the investment and compliance issues.

1. Professional Trustee.

In many situations, the client will be well-served by having a professional appointed as trustee of an SNT. This may be a corporate bank, trust company or lawyer who works in this field. Of course, this will likely mean increased expense compared to a family member; however, in most cases this will be well worthwhile. Most family members have never served as trustee of any kind of trust, much less an SNT. There could be a tendency to treat the trust money as their own or comingle the assets with their own. This is especially troublesome when the beneficiary with special needs is not capable of monitoring the trustee's actions. It is important to have a trustee who will take the time to get to know the beneficiary and who will investigate and understand their needs. The trustee must have the backbone to refuse to make inappropriate distributions that are not for the benefit of the beneficiary and also be flexible enough to make distributions that will enhance the quality of life of the beneficiary. However, not all professional trustees will take the time to do the job properly. Increasingly, courts are becoming less tolerant of SNT trustees who simply invest the money, take their fees and do nothing much else to benefit the beneficiary. Courts are holding trustees of an SNT to a higher standard, often requiring them to apply for government benefits on behalf of the trustee or make distributions that improve the quality of life of the beneficiary. For this reason, among others, many banks and trust companies will not serve as a trustee of an SNT. It is important to work with a trust company that seeks out this type of business and will do a good job.

When utilizing a corporate trustee, the practitioner make should incorporate their fee schedule into the trust document. Most banks and trust companies have a minimum annual fee or may have a minimum corpus requirement. In many cases, this will be an impediment to appointing a corporate trustee. It is important to establish relationships with professional trustees who seek out this type of business and who are flexible when it comes to minimum corpus requirements.

B. Trust Protector.

It is often appropriate to appoint someone or an entity as trust protector to have the authority or duty to oversee the trustee in an SNT since the beneficiary often cannot serve this role. For example, a beneficiary with cognitive impairment would not be able to review the accounts of the trustee. A trust protector can be given the power to

remove and replace a corporate trustee. A trust protector can have a number of roles, depending on state law and the trust instrument itself. It is important to carefully think through which powers are given to a trust protector, as these can vary widely. They can be merely administrative in nature or can be substantive. The trust should make clear whether the trustee has to follow the direction of the trust protector or whether the trust protector is merely acting in an advisory capacity. Depending on the powers given to the trust protector, fiduciary responsibility may attach thereto.

C. Trustee Discretion.

SNT practitioners frequently debate whether an SNT should include very specific distribution standards or standards that are broad in nature. The theory behind specific standards is the hope that it will provide clear guidance to trustees (and beneficiaries and family members) as to what is intended with respect to permissible distributions. The thought is that this will reduce any potential litigation risk or the need to seek court approval for distributions. Conversely, it is thought that broad standards allow the trustee to exercise their unfettered discretion to make a distribution to improve the quality of life of the beneficiary in accordance with the trust instrument. In fact, many corporate trustees actually prefer this to a specific standard. After all, it is very hard to anticipate at the time of drafting all the future possible needs of the beneficiary. One of the drawbacks of a broad standard is that the trustee often feels the need to seek court approval for certain distributions since they are not specifically stated in the trust. With respect to this issue, there is no "one size fits all" approach that can be applied to all trusts. Each case must be thought through and discussed with the relevant parties prior to drafting the trust.

One drafting issue with respect to trustee discretion that deserves some thought is whether the trustee should be permitted to make a distribution even if it reduces or eliminates the beneficiary's entitlement to government benefits. If this type of distribution would improve the quality of life of the beneficiary, then perhaps it makes sense to make the distribution even if it has a negative impact on government benefits.

1. Purchase of a Home.

The purchase of a home for someone with disabilities is something that can improve their quality of life for a long time. However, a home purchase often presents a number of complex issues at the time of purchase and during the time period that the beneficiary resides in the house. For this reason, many practitioners suggest that a beneficiary rent instead of owning a home. If the decision is made to purchase a home, a threshold question is whether the purchaser of the home should be the trust, the beneficiary, or some other third party. With respect to third party SNTs, it often makes sense for the SNT to own the home since there is no Medicaid payback with these types of trusts and the beneficiary is not able to convert an exempt asset (i.e., their homestead) to a non-exempt asset (i.e., cash).

When purchasing a home, the question invariably arises as to whether the purchase should be financed. If the trust owns the home, it may be difficult for the trustee to qualify for a mortgage. Of course, this situation can be ameliorated if the trust company and the mortgage company are owned by the same entity. If the home purchase transaction is structured so that the beneficiary owns the home, it may also be difficult to obtain a mortgage since many beneficiaries do not work or have poor credit. For this reason, it is common for home purchases to be all cash transactions.

2. Purchase of a Vehicle.

A trust can purchase a vehicle for the benefit of a beneficiary. It is important to consider who should be the owner of the vehicle. In many cases, it makes sense to title the vehicle in the name of the beneficiary or family member. This way, if a car accident occurs in which the beneficiary or family member was responsible, it will minimize the exposure of trust assets in any subsequent litigation. Additionally, it may be difficult to obtain auto insurance if the vehicle is owned by the trust. It is suggested that the trust holds a lien on the title of the car so the beneficiary or family member cannot sell the vehicle.

D. Trustee Powers.

It is important for the trustee to have the power to invest trust assets in non-income producing assets, such as a car or a house. Also, in an SNT, preservation of principal may not be paramount since the intent is to improve the quality of life of the beneficiary with special needs and the interests of the remaindermen typically fall behind the lifetime beneficiary.

E. Trust Amendment.

Due to a rapidly changing regulatory and legal landscape, it is possible that an SNT will need to be amended after it is executed. For example, if the beneficiary moves to another state and the new state's Medicaid agency doesn't agree with certain trust provisions and requires that they be removed or amended before Medicaid will be granted in that state. Another example is that the POMS are constantly changing and may cause the exempt trust to no longer be exempt. This is a major reason the special needs planning practitioner needs to incorporate flexibility into the trust so that it may be amended when necessary. Even though decanting or reformation may be available, it is almost always more cost effective and practical to amend the trust if the power to do so is included in the trust document.

F. Other Provisions.

The trust should also give the trustee the power to hire other professionals, including lawyers, accountants, and care managers.

IV. Common Errors.

The following are some common errors practitioners make when representing clients in special needs planning. These are by no means exhaustive, but merely a sampling of some of the things that can go wrong if careful attention is not paid to detail and all scenarios are not properly thought out. Each client's situation must be evaluated on its own as one size does not fit all when it comes to special needs planning.

A. **Retirement benefits.** If the client has substantial retirement benefits, the practitioner must consider the implications of the recently enacted SECURE Act. Previously, it often made sense to leave non-retirement assets to a third party SNT, while leaving retirement benefits to other beneficiaries. However, under SECURE it may now be more beneficial for the client to leave retirement benefits to a third-party SNT. Individuals who are disabled or chronically ill are considered Eligible Designated Beneficiaries (EDBs). While the general rule under the SECURE Act is that designated beneficiaries are required to withdraw the entire retirement account within 10 years, the previous "stretch" rules still apply for EDBs. A properly drafted third party SNT can qualify as an EDB, and the practitioner should ensure that accumulation language is included (as opposed to a conduit or pass through trust).

B. **Not being flexible in drafting.** The practitioner must carefully consider the needs of the trust beneficiary and circumstances of the particular matter. The trust should not be "cookie cutter," but rather an instrument that will provide flexibility to meet the beneficiary's needs for years to come. The goal of most clients is to improve the quality of life of the individual with special needs. They are relying on the practitioner to draft a document and put in place a plan that will adapt to the changing needs of the trust beneficiary and the ever-changing status of the law.

C. **Not creating a third party SNT for someone 65 or older.** There is no law prohibiting the creation and funding of a third-party trust for individuals with disabilities who are age 65 or older. This limitation applies only to first party SNTs. Testamentary third party SNTs may also be an effective planning tool for married seniors when one of the spouses may be facing a long-term care situation.

D. **Requiring mandatory distributions of income or principal.** SNTs must be purely discretionary trusts. If the special needs planning practitioner includes a provision allowing the beneficiary to demand distributions from the trust, it could undermine the entire purpose of the trust. Ideally, the trust should be designed to supplement, not replace, government benefits. Mandating trustee distributions could compromise the beneficiary's right to certain government benefits.

E. **Spending third party trust assets prior to first party trust assets.** Often, individuals with special needs are beneficiaries of both a first party SNT and a third party SNT. For example, they might have received a lawsuit settlement which was placed into a first party SNT, and the parents might have funded a third party SNT. Since the third party SNT does not have a Medicaid payback provision, it is recommended that (to the extent

possible) assets of the first party SNT be spent first prior to expending any third party SNT assets.

F. **Gifts to first party trust made by third parties.** While this may seem obvious, unfortunately, it does happen. Since the first party SNT must have a payback provision, it is imperative that any planning done by third parties include a third party SNT and that contributions by third parties go into the third party SNT and not the first party SNT.

G. **Failure to coordinate with other relatives' planning.** The practitioner should discuss with their client whether other family members are intending to leave assets to a child with a disability. After a client completes their estate planning, the client should write a "Dear Family" letter to family members and inform them of the trust that has been put into place and how they can contribute to it if they wish to leave anything to the individual. This is one of the benefits of utilizing an inter-vivos third party SNT.

H. **Failure to review and coordinate all beneficiary designations.** In any estate plan, but especially in a special needs situation, it is important to review and coordinate beneficiary designations. The intent and purposes of a third party SNT will be frustrated if the beneficiary designations of life insurance, retirement accounts, etc. leave assets outright to a person with special needs.

I. **Not preparing a letter of intent.** While not a legally binding document, a letter of intent is a critical component of a special needs plan. It provides a roadmap for future caregivers so that they can do the best job possible.

J. **Failure to appropriately consider proper trustee.** Too often, not enough time is spent discussing this particularly important decision. In many cases, the proper trustee is the key to the successful implementation of the plan and administration of the trust. Clients often wish to appoint a family member. However, family members often have a conflict of interest and have no experience serving as trustee. Serving as trustee of an SNT is even more complicated than serving as a trustee of a more traditional trust since the trustee must also be familiar with government benefit rules. In fact, some banks and trust companies refuse to serve as trustee of an SNT. Oftentimes, it makes sense to have co-trustees where the individual trustee can address the beneficiary's personal needs and the corporate trustee can handle the investment and compliance issues.

K. **Failure to consider a trust protector.** In an SNT, the beneficiary is often not able to monitor the actions of the trustee due to cognitive issues. Thus, a trust protector can serve a very useful oversight role in these cases. The trust protector can have a number of powers, including the power to make certain changes to the trust, the power to approve distributions, the power to change the trustee, among others. The practitioner should consider whether the trust protector will be a fiduciary. There are several states which have trust protector statutes, and these must be reviewed if the trust is governed by the laws of one of those states.

L. **Having remainder beneficiaries who are adverse to the beneficiary with disabilities.** Too often, families lose sight of the fact that the SNT was set up primarily for the benefit of the person with disabilities. Practitioners need to be mindful of potential conflicting and hostile family relationships which may impact the administration of the SNT. For example, if the sibling is a trustee and also a remainder beneficiary, the sibling may be hesitant to spend necessary money on the beneficiary for fear that their remainder interest will be diminished.

M. **Failure to include a contingent SNT in Will.** Many practitioners will not include an SNT in an estate plan because the family is not sure that the individual with special needs will ever need government benefits. In these situations, a contingent SNT works very well. The practitioner can draft the will leaving the assets either outright or in a non-SNT. If, at the time that the beneficiary becomes entitled to receive the assets, it is possible that government benefits may be in his future, then the SNT provisions can be triggered. This approach allows the decision on whether to utilize an SNT to be deferred, thereby giving all parties more time and information to make the proper decision.

N. **Prohibiting disqualifying distributions.** The goal of special needs planning is to improve the quality of life of the individual with special needs. In certain circumstances, the beneficiary may be better off if services or items are paid for by the trust even if this will have the effect of reducing or eliminating benefits. It is important that the trust allow the trustee to exercise its discretion in this regard.

O. **Include payback in third party trust.** Including a Medicaid payback provision in a third-party SNT is a serious error that can result in unhappy clients and even a malpractice claim. Many practitioners misunderstand the difference between first-party and third-party SNTs and assume that all SNTs require a Medicaid payback provision, which is not the case.

P. **Give SNT beneficiary with disabilities Crummey powers.** For tax planning purposes, it is often desirable for trust beneficiaries to have a Crummey right of withdrawal so that contributions to the trust qualify for the annual gift tax exclusion. If the trust beneficiary is receiving government benefits, however, it is possible that SSA or Medicaid could take the position that a disabled beneficiary's Crummey right of withdrawal could cause the assets of the trust to be available to that beneficiary. Additionally, the lapse of the power could be considered a gift. If estate and gift tax planning is important, consider granting Crummey powers to other beneficiaries, such as contingent remaindermen.

Q. **Not reviewing government benefits.** Clients are often unaware of the exact benefits they are receiving. Always review written documentation of benefit eligibility. For example, if a beneficiary receives only SSDI and Medicare and is not expected to receive means-tested benefits, an SNT may not be necessary.

R. **Knee-jerk SNT.** Practitioners often assume that an SNT is the best option, when in fact, it might not always be the case. In a third party SNT situation this can be addressed by using a contingent SNT. This allows for the creation of an SNT in the future if necessary.

Dear Family and Friends Letter Template

[Client Name]
[Client Address Line 1]
[Client Address Line 2]

Dear Family and Friends:

This is intended to let you know that I have recently completed updating my estate planning, which includes providing for [name of child]'s future. This has taken me many months to complete and entails some rather extensive estate and financial planning for [name of child]'s future needs if something happens to me.

My main purpose in notifying you about my personal plans is to make you aware of the existence of a special needs trust that is designed to hold various assets and funds for [name of child]'s benefit. In order for [name of child] to qualify or to maintain [his/her] current qualification for various government programs it is imperative that [he/she] not receive any monies or funds directly in [his/her] own name, including be named as beneficiary on any assets. Instead, anything that I or anyone else leaves [name of child] must go to the special needs trust established for [his/her] benefit. Otherwise, if [name of child]were to receive any funds outright, [his/her] eligibility for most government provided special needs programs would be jeopardized.

I am not asking you or anyone else to leave funds for [name of child]. My intention is to take care of [his/her] future needs myself. However, in the event you do want to leave something, I want to make you aware of the best way of doing so without jeopardizing [his/her] eligibility for these vital government programs that I anticipate [he/she] will need for the rest of [his/her] life. Quite simply, all you need to do is make sure that any funds are directed only to the trust, which is referred to as the: "[name of trust] dated [date of trust]."

Thank your understanding.

Sincerely,

[Client Name]

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LETTER OF INTENT GUIDELINES TO FAMILIES

No one else knows your child as well as you do, and no one ever could. You are a walking encyclopedia of your child's history, experiences, habits, and wishes. If your child has special needs, the family's history adds a helpful chapter to your child's book, one detailing their unique medical, behavioral, and educational requirements.

What would happen if you suddenly became unable to provide your child with the necessary supports they need? Without you, your child may become dependent on other caregivers who simply do not possess all of your personal knowledge and insight. However, there are steps you can take now to minimize the natural disruption and disorientation that will occur upon your death or incapacity.

One step is to prepare a letter of intent to help loved ones and your child manage a difficult transition when you no longer are the primary caregiver. A letter of intent is an important planning tool for parents of children with special needs (including adult children).

Although a letter of intent is one of the most important planning documents a parent can prepare, it is not a formal legal document that must be created by an attorney. The goal of a letter of intent is to memorialize your knowledge of your child's needs so that you can guide future caregivers, guardians, and/or trustees in providing the best possible care for your child. Simply put, a thoughtful letter of intent ensures that those who come after you need not waste precious time figuring out the best way to manage and care for your child.

The letter of intent may be addressed to anyone you wish – for example "To Whom it May Concern," "To my Guardian(s), Trustee(s) and Executor." At minimum, the letter should address the following points:

Family History: Where and when you were born, raised, and married, including anecdotes about your own siblings, grandparents, and other relatives or special friends. A description of your child's birth and their connections to specific family members or friends will complement your account of favorite memories and feelings about your child.

General Overview: A brief summary of your child's life to date and your general thoughts and hopes about the future for your child.

Daily Schedule: Because levels of functionality vary for each child and future caregivers may fail to recognize this fact, it is important to include a list of your child's daily routines, favorite activities, and events or tasks he loves or hates. Because a child's ability to contribute to even the most mundane aspects of family life builds self-esteem, it is important that the letter mention whether your child can help with tasks like doing the dishes or raking leaves. Alternatively, if your child loves "swiffing" the floor but folding clothes frustrates him, make sure future caregivers have this information.

Food: Describe your child's diet, including their favorite foods and any specific manner in which the food should be prepared or served. Be certain that the letter also includes a list of foods to which your child is allergic, simply does not like or otherwise may react adversely due to medication.

Medical Care: Describe in detail your child's disability, medical history, and allergies, as well as current doctors, therapists, and hospitals. Detail the frequency of your child's medical and therapy appointments and the purposes and goals of these sessions. List current medications, including how they are administered and for what purpose, and be careful to describe all medications that have not worked for your child in the past.

Education: Detail your child's educational experiences and describe your desire for your child's future education, including regular and special classes, specific schools, related services, mainstreaming, extracurricular activities, and recreation. Discuss your wishes regarding the types of educational emphasis, i.e., vocational, academic, or total communication, and name any specific programs, teachers, or related service providers that you prefer to be part of your child's overall life plan.

Benefits Received: List the types of governmental benefits your child receives, including Medicaid, Medicare, SSI/SSDI, Supplemental Nutrition Assistance Program (food stamps), and housing assistance. Detail the agencies' contact information, identification numbers for your child's case(s), the recertification process for each benefit, including important dates and other reporting requirements.

Employment: Describe the types of work and work environments your child may enjoy; i.e., open employment with supervision, a sheltered workshop, or an activity center. List any companies of which you are aware that provide employment in the community and may be of specific interest to your child.

Residential Environment: Describe your child's living arrangements with family, friends, or other organizations. If your child will be unable to continue living with these individuals after you stop being the primary contact for their care, describe what you consider to be the best alternative arrangements. For instance, explain whether you prefer that your child live in a group home or institution located in the same community, the preferred size of the institution, or that your child has a single room or roommate.

Social Environment: Mention the types of social activities your child enjoys, i.e., sports, dances, or movies. Indicate whether your child should be given spending money and, if so, how he has spent money in the past. The letter of intent also should note whether your child takes and/or enjoys taking vacations and, if so, whether he has a favorite travelling companion.

Religion: Specify your child's religion and any local place of worship your family attends. List all local clergy that may be familiar with your child and your family. Describe your child's religious education and indicate whether this is of interest to your child.

Behavior Management: Describe any current behavior management program that has a positive impact on your child and discuss any other behavior management programs that were unsuccessful in the past.

Final Arrangements: List your desires for your child's final arrangements, including whether you have planned for a funeral, cremation or burial, and any cemetery, monument, religious service, or specific clergy to officiate the proceeding.

Other Information: Include any other information that you believe will provide the best possible guidance to the person who assumes responsibility for caring for your child.

Once you prepare, sign and date the letter of intent, you should review the document annually and update it as necessary. It is important that you let your child's potential future caregiver know the letter of intent exists and where it can be accessed; even better, you can review the document with the caregiver on an annual basis. The letter of intent should be placed with all of your other relevant legal and personal documents concerning your child.

The letter of intent can be a difficult and extremely emotional document to write, as it is often the first time parents actually envision their child with special needs navigating this world without them. However, once it is completed, the first important step has been taken toward creating a detailed road map for future caregivers and trustees. As a parent of a child with special needs, you also may be relieved to know that you are ensuring the highest quality of life for your child by laying the foundation for as seamless a transition as possible after you are gone.

Administering a Special Needs Trust

A Handbook For Trustees (2024 Edition)

SNA
SPECIAL NEEDS ALLIANCE

Attorneys for special needs planning.

Administering a Special Needs Trust
TABLE OF CONTENTS

Administering a Special Needs Trust: A Handbook for Trustees

Introduction and Definition of Terms

"Special Needs" trusts are complicated and can be hard to understand and administer. They are like other trusts in many respects—the general rules of trust accounting, law and taxation apply—but unlike more familiar trusts in other respects. The very notion of "more familiar" types of trusts will, for many, be amusing—most people have no particular experience dealing with formal trust arrangements, and special needs trusts are often established for the benefit of individuals who would not otherwise expect to have experience with trust concepts.

The essential purpose of a special needs trust is usually to improve the quality of an individual's life without disqualifying him or her from eligibility for public benefits. Therefore, one of the central duties of the trustee of a special needs trust is to understand what public benefits programs might be available to the beneficiary and how receipt of income, or provision of food or shelter, might affect eligibility. Because there are numerous programs, competing (and sometimes even conflicting) eligibility rules, and at least two different types of special needs trusts to contend with, the entire area is fraught with opportunities to make mistakes. Because the stakes are often so high—the public benefits programs may well be providing all the necessities of life to the beneficiary—a good understanding of the rules and programs is critically important.

The essential purpose of a special needs trust is usually to improve the quality of an individual's life without disqualifying him or her from eligibility to receive public benefits.

Before delving into a detailed discussion of special needs trust principles, it might be useful to define a few terms:

GRANTOR (sometimes "Settlor" or "Trustor")—the person who establishes the trust and generally the person whose assets fund the trust. There might be more than one grantor for a given trust. The tax agency may define the term differently than the public benefits agency. Special needs trusts can make this term more confusing than other types of trusts, since the true grantor for some purposes may not be the same as the person signing the trust instrument. If, for example, a parent creates a trust for the benefit of a child with a disability, and the parent's own money funds the trust, the parent is the grantor. In another case, where a parent has established a special needs trust to handle settlement proceeds from a personal injury lawsuit or improperly directed inheritance, the minor child (through a guardian) or an adult child will be the grantor, even though he or she did not decide to establish the trust or sign any trust documents.

TRUSTEE—the person who manages trust assets and administers the trust provisions. Once again, there may be two (or more) trustees acting at the same time. The grantor(s) may also be the trustee(s) in some cases. The trustee may be a professional trustee (such as a bank trust department or a lawyer), or may be a family member or trusted adviser—though it may be difficult to qualify a non-professional to serve as trustee.

BENEFICIARY—the person for whose benefit the trust is established. The beneficiary of a special needs trust will usually (but not always) be disabled. While a beneficiary may also act as trustee in some types of trusts, a special needs trust beneficiary will almost never be able to act as trustee.

DISABILITY—for most purposes involving special needs trusts, "disability" refers to the standard used to determine eligibility for Social Security Disability Insurance or Supplemental Security Income benefits: the inability to perform any substantial gainful employment.

INCAPACITY (sometimes Incompetence)—although "incapacity" and "incompetence" are not interchangeable, for our purposes they may both refer to the inability of a trustee to manage the trust, usually because of mental limitations. Incapacity is usually important when applied to the trustee (rather than the beneficiary), since the trust will ordinarily provide a mechanism for transition of power to a successor trustee if the original trustee becomes unable to manage the trust. Incapacity of a beneficiary may sometimes be important as well. Not every disability will result in a finding of incapacity; it is possible for a special needs trust beneficiary to be disabled, but not mentally incapacitated. Minors are considered to be incapacitated as a matter of law. The age of majority differs slightly from state to state, though it is 18 in all but a handful of states.

REVOCABLE TRUST—refers to any trust which is, by its own terms, revocable and/or amendable, meaning able to be undone, or changed. Many trusts in common use today are revocable, but special needs trusts are usually irrevocable, meaning permanent or irreversible.

IRREVOCABLE TRUST—means any trust which was established as irrevocable (that is, no one reserved the power to revoke the trust) or which has become irrevocable (for example, because of the death of the original grantor).

SOCIAL SECURITY DISABILITY INSURANCE—sometimes referred to as SSDI or SSD, this benefit program is available to individuals with a disability who either have sufficient work history prior to becoming disabled or are entitled to receive benefits by virtue of being a dependent or survivor of a disabled, retired, or deceased insured worker. There is no "means" test for SSDI eligibility, and so special needs trusts may not be necessary for some beneficiaries—they can qualify for entitlements like SSD and Medicare even though they receive income or have available resources. SSDI beneficiaries may also, however, qualify for SSI (see below) and/or Medicaid benefits, requiring protection of their assets and income to maintain eligibility. Of course, just because a beneficiary's benefits are not means-tested, it does not follow that the beneficiary will not benefit from the protection of a trust for other reasons.

SUPPLEMENTAL SECURITY INCOME—better known by the initials "SSI," this benefit program is available to low-income individuals who are disabled, blind or elderly and have limited income and few assets. SSI eligibility rules form the basis for most other government program rules, and so they become the central focus for much special needs trust planning and administration.

MEDICARE—one of the two principal health care programs operated and funded by government—in this case, the federal government. Medicare benefits are available to all those age 65 and over (provided only that they would be entitled to receive Social Security benefits if they chose to retire, whether or not they actually are retired) and those under 65 who have been receiving SSDI for at least two years. Medicare eligibility may forestall the need for or usefulness of a special needs trust. Medicare recipients without substantial assets or income may find that they have a difficult time paying for medications (which historically have not been covered by Medicare but began to be partially covered in 2004) or long-term care (which remains largely outside Medicare's list of benefits).

MEDICAID—the second major government-run health care program. Medicaid differs from Medicare in three important ways: it is run by state governments (though partially funded by federal payments), it is available to those who meet financial eligibility requirements rather than being based on the age of the recipient, and it covers all necessary medical care (though it is easy to argue that Medicaid's definition of "necessary" care is too narrow). Because it is a "means-tested" health care program, its continued availability is often the central focus of special needs trust administration. Because Medicare covers such a small portion of long-term care costs, Medicaid eligibility becomes centrally important for many persons with disabilities.

The Most Important Distinction

Two entirely different types of trusts are usually lumped together as "special needs" trusts. The two trust types will be treated differently for tax purposes, for benefit determinations, and for court involvement. For most of the discussion that follows, it will be necessary to first distinguish between the two types of trusts. The distinction is further complicated by the fact that the grantor (the person establishing the trust, and the easiest way to distinguish between the two trust types) is not always the person who actually signs the trust document.

"Self-Settled" Special Needs Trusts

Some trusts are established by the beneficiary (or by someone acting on his or her behalf) with the beneficiary's funds for the purpose of retaining or obtaining eligibility for public benefits—such a trust is usually referred to as a "self-settled" special needs trust. The beneficiary might, for example, have received an outright inheritance, or won a lottery. By far the most common source of funds for "self-settled" special needs trusts, however, is proceeds from a lawsuit—often (but not always) a lawsuit over the injury that resulted in the disability. Another common scenario requiring a person with a disability to establish a self-settled trust is when they receive a direct inheritance from a well-intentioned, but ill-advised relative.

A given trust may be treated as having been "established" by the beneficiary even if the beneficiary is completely unable to execute documents, and even if a court, family member, or lawyer representing the beneficiary actually signed the trust documents. The key test in determining whether a trust is self-settled is to determine whether the beneficiary had the right to outright possession of the proceeds prior to the act establishing the trust. If so, public benefits eligibility rules will treat the beneficiary as having set up the trust even though the actual implementation may have been undertaken by someone else acting on their behalf. Virtually all special needs trusts established with funds recovered in litigation or through a direct inheritance will be "self-settled" trusts.

Self-settled special needs trusts are different from third-party trusts in two important ways. First, self-settled trusts must include a provision directing the trustee, if the trust contains any funds upon the death of the beneficiary, to pay back anything the state Medicaid program has paid for the beneficiary. Second, in many states, the rules governing permissible distributions for self-settled special needs trusts

continued on page 6

continued from page 5

are significantly more restrictive than those controlling third-party special needs trusts.

Because Social Security law specifically describes self-settled special needs trusts, these instruments are sometimes referred to by the statutory section authorizing transfers to such trusts and directing that trust assets will not be treated as available and countable for SSI purposes. That statutory section is 42 U.S.C. §1396p(d)(4)(A), and so self-settled special needs trusts are sometimes called, simply, "d4A" trusts.

"Third-party" Special Needs Trusts

The second type of special needs trust is one established by someone other than the person with disabilities (usually, but not always, a parent) with assets that never belonged to the beneficiary. It is often used, when proper planning is done for a disabled person's family, to hold an inheritance or gift. Without planning, a well-meaning family member might simply leave an inheritance to an individual with a disability. Even though it may be possible to set up a trust after the fact, the funds will have been legally available to the beneficiary. That means that any trust will probably be a "self-settled" special needs trust, even though the funds came from a third party.

> Some trusts are established by the beneficiary for the purpose of retaining or obtaining eligibility for public benefits with the beneficiary's funds. By far the most common source of funds for "self-settled" special needs trusts is proceeds from a lawsuit—often (but not always) a lawsuit over the injury that resulted in the disability.

Parents, grandparents and others with the foresight to leave funds in a third party special needs trust will provide significantly better benefits to the beneficiary who has a disability. This type of trust will not need to include a "payback" provision for Medicaid benefits upon the beneficiary's death. During the beneficiary's life, the kinds of payments the trust can make will usually be more generous and flexible.

The "Sole Benefit" Trust

Although there are two primary types of special needs trusts, there is actually a third type that might be appropriate under certain unusual circumstances. Because Medicaid rules permit applicants to make unlimited gifts to or "for the sole benefit of" disabled children or spouses, some individuals with assets may choose to establish a special needs trust for a child or grandchild with disabilities in hopes of securing eligibility for Medicaid for both themselves as grantor and for the disabled beneficiary. A number of states are very restrictive in their interpretation of the "sole benefit" requirement, so that such trusts are rarely seen. In many ways they look like a hybrid of the two other trust types; they may be taxed and treated as third-party trusts, but require a payback provision like a self-settled trust (at least in some states).

The Second Most Important Distinction

Once the type of trust is determined, the next important issue is discerning the type of government program providing benefits. Some programs (like SSDI and Medicare) do not impose financial eligibility requirements; a beneficiary receiving income and all his or her medical care from those two programs might not need a special needs trust at all, or might benefit from more flexibility given to the trustee. A recipient of SSI and/or Medicaid, however, may need more restrictive language in the trust document and closer attention on the part of the trustee.

SSDI/Medicare Recipients

Neither Social Security Disability Insurance benefits nor Medicare are "means–tested." Consequently, it may be unnecessary to create a special needs trust for someone who receives benefits only from those two programs. After 24 months of SSDI eligibility, the beneficiary will qualify for Medicare benefits as well, so it may be appropriate to provide special needs provisions to get the SSDI recipient through that two-year period, during which he or she may rely on Medicaid for medical care. Restrictive special needs trust language may actually work against an SSDI beneficiary if it prevents distribution of cash to the beneficiary in all circumstances; an SSDI recipient will almost always benefit from broad language giving more discretion to the trustee.

Some SSDI/Medicare recipients may also receive SSI and/or Medicaid benefits. It may be critically important for those individuals to have strict special needs language controlling use of any assets or income that would otherwise be available. As the Medicare prescription drug benefit evolves over the next few years, this concern may be somewhat lessened—but for the moment, it remains true that availability of the drug coverage provided by Medicaid is critically important to many Medicare recipients.

Even an SSDI/Medicare beneficiary who does not receive any SSI or Medicaid benefits may be a good candidate for special needs trust planning. Future developments in public benefits programs, including housing, are uncertain, but constant budget pressure may well make benefits now taken for granted completely or partially indexed to income and/or assets in the future. Medical conditions also change, of course, and some persons with disabilities living in the community who presently receive adequate support from

Medicare may one day become dependent on Medicaid for services not available under Medicare–like long term care.

SSI/Medicaid Recipients

Most special needs trust beneficiaries are eligible for (or seeking eligibility for) Supplemental Security Income payments. In many states, receipt of SSI payments automatically qualifies one for Medicaid eligibility. Many other government programs explicitly rely on SSI eligibility rules as well, so that SSI eligibility rules become the central concern for those charged with administering special needs trusts.

Veterans' Benefits

"Veterans' benefits" is the term used to describe the benefits available to veterans, the surviving spouses, children or parents of a deceased veteran, dependents of disabled veterans, active duty military service members, and members of the Reserves or National Guard. These benefits are administered by the U.S. Department of Veterans Affairs ("VA").

> Parents, grandparents and others with the foresight to leave funds in a third-party special needs trust will provide significantly better benefits to a beneficiary with disabilities.

The benefits available to veterans include monetary compensation (based on individual unemployability or at least ten-percent disability from a service-connected condition), pension (if permanently and totally disabled or over the age of 65 and have limited income and net worth), health care, vocational rehabilitation and employment, education and training, home loans and life insurance. Although the pension is available to low-income veterans, it is important to note that some income, such as child's SSI or wages earned by dependent children, is excluded when determining the veteran's annual income. Also keep in mind that a service-connected disability payment will not offset SSDI, but any VA disability payment will offset SSI.

The benefits available to dependents and survivors of the veteran include Dependency and Indemnity Compensation ("DIC") and, in certain circumstances, home loans.

Transferring a VA recipient's assets into a special needs trust may not be fully effective. According to VA interpretation, the assets of such a trust will be counted as part of the claimant's net worth when calculating an improved pension. It is important to remember that the VA may place a "freeze" on new enrollees in order to manage the rapid influx of new veterans or older veterans who did not previously enroll for services. Therefore, it is important to evaluate current and future need for VA services in order to anticipate and plan for a situation where a person is otherwise eligible for VA benefits but, due to a freeze, cannot receive services. Under a new law, attorneys must become accredited with the VA to advise clients in this area.

Subsidized Housing

FEDERAL SUBSIDIZED HOUSING

The U.S. Department of Housing and Urban Development ("HUD") provides opportunities to low-income individuals and families to rent property at a cost that is lower than the open market. This is especially important to those people who are expected to pay for their shelter costs (rent or mortgage, plus utilities) with their insufficient SSI income. There are two issues to consider when evaluating the role of special needs trusts and subsidized housing: the initial eligibility for subsidized housing and the rent determination.

Eligibility for subsidized housing depends on the family's annual income. Annual income includes earned income, SSI, SSDI, pension, unemployment compensation, alimony, and child support, among other items. Annual income also includes unearned income, which is comprised, in part, of interest generated by assets. If the family has net family assets in excess of $5,000, the annual income includes the greater of the actual income derived from all net family assets or a percentage of the value of such assets based on the current passbook savings rate, as determined by HUD.

Assets that are not included as income upon receipt are lump sums, such as inheritances and insurance settlements for losses (although the income they generate will be countable), reimbursement for medical expenses, PASS set-asides, work training programs funded by HUD and the income of a live-in aide.

In general, to qualify for federal subsidized housing, an individual's countable income may not exceed eighty percent of the median income in the area to be considered "low income", and the individual's income may not exceed fifty percent of the median income to be considered "very low income". The result is a disparity in eligibility depending on where the person resides within the county, state, and region of the country.

There is no asset limit to be eligible for federal subsidized housing, although as described above, if countable assets are greater than $5,000, the interest income generated will be counted towards eligibility. If a person transfers an asset for less than its fair market value, then HUD will treat the asset as if it were still owned by the individual for two years after the transfer. HUD will assume that the asset generates income at the passbook rate and will include that income in calculating the individual's rent. Therefore, it is very likely that HUD will treat transfers to a special needs trust as a transfer for less than fair market value and, for the next two years, will include

continued on page 8

continued from page 7

the interest generated by the special needs trust as income to the individual, either at the passbook rate or the actual earnings, whichever is greater.

Special Needs Trusts are excluded from family assets and the income generated by the trust assets is not included once the two-year penalty period has expired. It is important to note that, similar to other programs such as Medicaid and SSI, "regular" distributions from a special needs trust, even if made to a third-party provider, will be treated as countable income, even if used for non-food and shelter items.

> In many states, receipt of SSI payments automatically qualifies one for Medicaid eligibility. Many other government programs explicitly rely on SSI eligibility rules as well, so that SSI eligibility rules become the central concern for those charged with administering special needs trusts.

The second issue relating to subsidized housing and a special needs trust is determining the monthly rent. Generally, an individual/family's rent will be thirty percent of their adjusted gross income. Similar to treatment under the threshold eligibility rules, the special needs trust and the income generated by trust assets are excluded, but "regular" distributions made directly to the beneficiary (as opposed to a third-party provider of goods or services) will be considered as income.

SECTION 8

Section 8 is a voucher program that is administered by HUD but managed by local public housing authorities ("PHA") or metropolitan housing authorities ("MHA"). The tenant pays their rent, typically thirty percent of their net adjusted income, to the landlord. The PHA pays the remaining balance due, which is called the voucher, to the landlord. The rent is based on the market value for the area and established by the PHA according to payment standards issued by HUD.

While a family member generally cannot serve as a Section 8 landlord, it is possible for a special needs trust to do so, even if the trustee is a family member. Although there are special rules applicable to a Section 8 landlord, it can be a beneficial relationship. The trust beneficiary would pay rent to the trustee (using the thirty percent of income rule) and the PHA would pay the remainder to the trustee.

It is important to investigate how your local housing authority's rules differ from the general rules listed above.

Temporary Assistance for Needy Families ("TANF")

TANF provides assistance and work opportunities to needy families. TANF is administered locally by the states, but is overseen by The Office of Family Assistance ("OFA"), which is located in the United States Department of Health and Human Services, Administration for Children and Families. TANF is a result of combining two other programs: Aid to Families with Dependent Children ("AFDC") and Job Opportunities and Basic Skills Training ("JOBS"). Because TANF is administered on a local level, the program and eligibility rules vary greatly from state to state. However, it is safe to assume that distributions directly made to the beneficiary of a special needs trust, or to the beneficiary's family if a minor, may be considered income and will impact eligibility for TANF.

Other Means-Tested Benefits Programs

State supplements to SSI and other government benefit programs, like vocational rehabilitation services, also play important roles in the lives of many individuals with disabilities. Because the welter of eligibility programs is confusing and the reach of most other programs is not as broad as those described in detail here, those other programs are not described in any depth. In analyzing the proper approach to establishment or administration of a special needs trust, however, care should be taken to consider all the available program resources and restrictions on use of trust funds mandated by those programs.

Eligibility Rules for Means- Tested Programs

As previously noted, the primary program with financial eligibility restrictions is SSI, the Supplemental Security Income program. Because the concepts are central to an understanding of other eligibility rules, and because many other programs explicitly utilize SSI standards, the SSI rules become the most important ones to grasp. They are described here in a general way, with a few notations where other programs (particularly long-term care Medicaid) differ from the SSI rules.

Income

SSI eligibility requires limited income and assets. SSI rules have a simple way of distinguishing between income and assets: Money received in a given month is income in that month, and any portion of that income remaining on the first day of the next month becomes an asset. SSI rules also distinguish between what is "countable" or "excluded," "regular" or "irregular," and "unearned" or "earned" income. "Countable" income means that it is used to compute eligibility and benefit amount. "Excluded" means that it is not counted. "Regular" means that it is received on a periodic basis, at least two or more times per quarter or in

consecutive months, and "irregular" or "infrequent" means that it is not periodic or predictable. "Unearned" means that it is passively received, such as SSDI benefits or bank account interest. "Earned" means that work is performed in exchange for the income. An SSI recipient is permitted to receive a small amount of any kind of income ($20 per month) without reducing benefits. That amount is sometimes referred to as the SSI "disregard" amount.

Each classification or grouping has a somewhat different rule, and it is an understatement to call these income rules "confusing." Any unearned income reduces the SSI benefit by the amount of the income, so investment income or gifted money simply reduces the benefit dollar for dollar, less the disregard. Earned income is treated more favorably, only reducing benefits by about half of the earnings. This is designed to encourage SSI recipients to return to the workforce. Keeping in mind that disability is defined as "unable to perform any substantial gainful activity," it is easy to see that any significant amount of earned income will eventually imperil SSI eligibility and, since trust administration does not usually involve earned income in any event, we will not attempt to deal with those issues here.

SSI also has a concept of "in-kind support and maintenance" (ISM) that is central to much understanding of special needs trust administration. Any payment from a third party (including a trust) for necessities of life—food or shelter (note that the federal government deleted "clothing" from the list of necessities in March 2005) to a third party provider of goods or services—will be treated as countable income, albeit subject to special rules for calculating its effect.

The effect of receiving ISM on SSI benefits is different from the receipt of cash distributions. Where as cash payments reduce the SSI payment dollar for dollar, ISM reduces the benefit by the lesser of the presumed maximum value of the items provided or an amount calculated by dividing the maximum SSI benefit by three and adding the $20 disregard amount.

For 2024, the maximum federal SSI benefit for a single person is $943. One third of that amount is $314.33, and so the maximum reduction in benefits caused by ISM (no matter how high the value) is $334.33 per month. The meaning of that confusing collection of information is best illustrated using an example (CAUTION: some states provide SSI supplemental payments that affect this calculation).

Consider John, who is disabled as a result of his serious mental illness. He has no work history, and he does not qualify for SSDI. He is an adult, living on his own. He qualifies for the maximum federal SSI benefit of $943; he lives in a state which does not provide an SSI supplement.

If John's mother gives him $100 cash per month (for food and cigarettes), he is required to report that as countable unearned income each month. Although SSI may take two or three months to accomplish the adjustment, the program will eventually withhold $80 ($100 minus the $20 disregard) from his benefit for each month in which his mother makes a cash gift to him. The same result will obtain if John's mother is trustee of a special needs trust for John and the cash comes from that trust.

If, however, John's mother does not give him the $100 directly, but instead purchases $70 worth of food and $30 worth of video games each month, only the food will affect his SSI payment—reducing it by $50 ($70 minus the $20 disregard). If she purchases $20 worth of food and $80 worth of video games, there will be no effect at all—the food purchase is within the $20 monthly disregard amount. Similarly, if she purchases $20 worth of video games and $30 worth of movie tickets, there will be no effect—provided that the movie tickets cannot be turned in for cash (because if the movie tickets can be converted to cash, John could—even if he does not—convert the movie tickets into payment for food or shelter).

In other words, the effect of John's mother's payments to him or for his benefit changes with the nature of her payments. Any cash she provides to him (over the $20 monthly amount ignored by SSI) reduces his SSI payment directly. Direct purchase of items other than food or shelter does not affect his SSI, so long as the purchased items cannot be converted to food or shelter. Finally, any payment she makes for food or shelter reduces his SSI check as well, but not as harshly as cash payments directly to John.

Now suppose that John's mother decides to give up on trying to work around the strictures of SSI rules, and she simply pays his rent at an adult care facility that provides his meals. Assume that the facility costs her $1500 per month, which she pays from her own pocket. Because of the ISM rules, John's SSI benefit will be reduced by only $334.33 per month, and so his SSI check will be reduced to $608.67. Critically important, however, John will still qualify for Medicaid benefits in most states because he receives some amount of SSI. If the adult care home payment comes from a special needs trust for John's benefit, the same result will occur, assuming that the room and board portion of the payment exceeds $334.33. Incidentally, the same result will also obtain if John's mother simply takes him in and allows him to live and eat with her without charging him rent.

Now assume that John does have a work history before becoming disabled, and that he qualifies to receive $700 per month from SSDI. Because he has been receiving SSDI for more than two years, he also qualifies for Medicare. Because his countable income is less than $943, he continues to receive $263 in SSI benefits ($20 of the SSD is disregarded), and qualifies for Medicaid as well (we will ignore the effect

continued on page 10

continued from page 9

of the QMB and SLMB programs for qualified, special low-income Medicare beneficiaries, and the Medicare Part B premium which would ordinarily be withheld from his SSDI check). Now if John's mother pays his rent at the adult care home, or takes him into her own home, he will lose his SSI altogether—since he is receiving less than $334.33 per month from SSI, the effect of the ISM rules will be to knock him off the program. Unless he separately qualifies for Medicaid, he will also lose his coverage under that program. The income strictures are the same or similar for other programs, with one important exception. In some states, but not all, eligibility for community or long-term care Medicaid is also dependent on countable income. The income tests vary. In some, you can "spend down" excess income over the limit to become eligible. In others, if countable income exceeds the benefit "cap" (like SSI), you cannot become eligible at all.

Some states also attempt to limit expenditures from self-settled (and even third-party) special needs trusts, and can require amendments to the language of those trusts in order to allow eligibility. While a good argument can be made that the Medicaid program does not have that ability, as a practical matter, the trustee of the special needs trust will have to either litigate that issue or acquiesce in the Medicaid agency's demands.

Assets

The limitation on assets for SSI eligibility may be somewhat easier to master, or at least to describe. A single person must have no more than $2,000 in available resources in order to qualify for SSI. Some types of assets are not counted as available (called "non-countable"), including the beneficiary's home, one automobile, household furnishings, prepaid burial amounts plus up to $1500 set aside for funeral expenses (or life insurance in that amount), tools of the beneficiary's trade, and a handful of other, less important items. Each of these categories of assets is subject to special rules and exceptions, so it is easy to become tangled in the asset eligibility structure.

Deeming

The SSI program considers portions of the income and assets of non-disabled, ineligible parents of minor disabled children and of an ineligible spouse living with the SSI recipient as available, and countable for eligibility purposes. This is called "deeming". A certain portion of the ineligible person's income and assets is considered as necessary for his or her own living expenses, and therefore is excluded.

As soon as a child reaches age 18, parental deeming no longer occurs, even if the child continues to live in the household. If spouses voluntarily separate and live in different households, then deeming from the separate spouse or parent also ends. However, in both instances, if the separate person continues to provide support or maintenance to the SSI eligible individual, it will still count as income as described above unless a Court orders it to be deposited directly into the trust. There is also a limited exception to all parental deeming for a severely disabled minor child returning home from an institution or whose condition would otherwise qualify them for institutionalization, which is called a waiver.

"I Want to Buy a..." or "I Want to Pay for..."

What do these complicated rules mean for expenditures from a special needs trust? In-kind purchases, meaning purchase of goods or services for the benefit of the beneficiary, only potentially affect the SSI benefit amount, and not Medicaid benefits, although the Medicaid agency may restrict expenditures for approved things. There are a number of specific purchases that frequently recur:

Home, Upkeep and Utilities

Keep in mind that SSI's in-kind support and maintenance (ISM) rules deal specifically with payments for "food and shelter." The Social Security Administration includes only these items as food and shelter:

1. Food
2. Mortgage (including property insurance required by the mortgage holder)
3. Real property taxes (less any tax rebate/credit)
4. Rent
5. Heating fuel
6. Gas
7. Electricity
8. Water
9. Sewer
10. Garbage removal

The rules make special note of the fact that condominium assessments may in some cases be at least partial payments for water, sewer, garbage removal and the like.

In other words, a payment for rent will implicate the ISM rules, as will monthly mortgage payments. The outright purchase of a home, whether in the name of the beneficiary or the trust, will not cause loss of SSI (although it may reduce the beneficiary's SSI benefit for the single month in which the home is purchased). This brings up another consideration. Purchase of a home in the trust's name will subject it to a Medicaid "payback" requirement on the death of the beneficiary, whereas purchase in the name of the beneficiary may allow other planning that will avoid the home becoming part of the payback. This complicated interplay of trust rules, ISM definition, estate-recovery rules, and home ownership

makes this area of special needs trust administration particularly fraught with difficulty.

However, the Medicaid state agency's treatment of distributions from special needs trusts may differ from the Social Security interpretation—especially when the beneficiary of a self-settled trust is eligible for Medicaid benefits. For example, contrary to putting the house in the individual's name, a state may require that any purchase of a home by such a trust would result in title being held in the trust's name, thereby ensuring that the state will at least receive the proceeds from the sale of the residence upon the death of the beneficiary.

Clothing

Until March 7, 2005, purchase of clothing by a trust was considered as ISM for SSI, similar to shelter and food. Since then, a clothing purchase for the beneficiary will not affect the benefit amount or eligibility, whether the clothing in question is special garments related to the disability or just ordinary street clothes and shoes. Not all state Medicaid regulations reflect this change.

Phone, Cable, and Internet Services

Other than those utilities listed above, there is no federal limitation on utility payments. In other words, the trust can pay for cable, telephone, high-speed internet connection, newspaper, and other "utilities" not on the list.

Vehicle, Insurance, Maintenance, Gas

Purchase of a vehicle and maintenance (including gas and insurance) is permitted under federal law. Note that there is a mechanical difficulty in providing gasoline without providing cash that could be converted to food or shelter. One technique which has worked well has been to arrange for the beneficiary to have a gas-company credit card. Because eligibility for such cards is easier to meet, and because the cards cannot be used to purchase groceries, administration of the credit account is easier to set up and monitor, and the card can then be billed directly to the trust.

Some state Medicaid agencies put limitations on the value, type, and title ownership of vehicles, such as only allowing a vehicle valued at up to $5,000, handicapped-equipped, or requiring a lien in favor of the payback trust on the title. The SSI program does not specifically require or monitor such limitations.

Pre-paid Burial/Funeral Arrangements

Nothing in federal law prohibits or restricts use of special needs trust funds for purchase of burial and funeral arrangements during the beneficiary's lifetime— except to the extent that the beneficiary has access to the funds used to pay for the arrangements, and thereby subject to the asset limitations affecting SSI recipients. State Medicaid agencies may limit the value of the burial contract. It is important to ask for an "irrevocable, pre-paid" funeral plan.

Tuition, Books, Tutoring

No limit under either federal or state law. This is an excellent use of special needs trust funds.

Travel and Entertainment

Once again, no limit except that there may be some concern about payment for hotels. When the beneficiary still maintains a residence at home, the hotel stay and restaurant may be considered "shelter" and "food" expenses. Some states may impose limitations on companion travel not found in federal law. These might include not allowing recipients to have the special needs trust pay for more than one traveling companion, the companion must be necessary to provide care, and the companion may not be a person obligated to support the beneficiary such as a minor beneficiary's parent. Note that foreign travel can have two other adverse effects: (1) airline tickets to foreign destinations, if refundable, will be treated as being convertible into food and shelter, and (2) if an SSI recipient is out of the country for more than a month, he or she may lose eligibility until return. For those reasons, foreign travel, unlike domestic travel, usually must be limited in time.

> As soon as a child reaches age 18, parental deeming no longer occurs even if the child continues to live in the household.

Household Furnishings and Furniture

The trust can be used to purchase appliances, furniture, fixtures and the like. Before March 2005, there was a theoretical concern in the SSI program that the value of household furnishings might exceed an arbitrary limit and affect the beneficiary's eligibility; that value limit has now been removed.

Television, Computers and Electronics

There is no specific limitation on purchase of household televisions or other electronic devices, although under SSI rules the individual is only allowed to own "ordinary household goods" that are not kept for collectible value and are used on a regular basis. The trust can also provide a computer for the beneficiary, plus software and upgrades.

Durable Medical Equipment

There is no federal limitation on any medical related equipment, but individual states may limit purchase of some equipment as not being "necessary." Problem areas could be if the equipment could also be considered as recreational, such as a heated swimming pool needed for arthritic or other joint conditions.

continued on page 12

continued from page 11

Care Management

No federal limitation, but many states attempt to limit payments for care or management if made to a family member or other relative, especially if there is an obligation of support (e.g., parents of minor children).

Therapy, Medications, Alternative Treatments

Same principle as durable medical equipment, above, so long as the state does not regulate the treatment, there is no federal limitation.

Taxes

No federal limitation, but states may attempt to direct trust language on what taxes can be paid for, such as taxes incurred as a result of trust assets or at the death of the beneficiary. Since it is difficult to imagine an SSI or Medicaid beneficiary having significant non-trust income, it is hard to see how this limitation is so much troublesome as it is quarrelsome.

Legal, Guardianship and Trustee Fees

At least some states allow legal, guardianship, and trustee fees to be paid from the trust, although some federal law indicates that payment of guardian's fees or guardian's attorney fees may really benefit the guardian and not the beneficiary. Payments for trust administration expenses, including the trust's attorney's fees, are clearly permissible under both federal and state law, and are rarely limited beyond reasonableness standards.

> It is generally beneficial for a self-settled special needs trust to be a grantor trust. This is true because the tax rates for non-grantor trusts are tightly compressed, and the highest marginal tax rate on income is reached very quickly for trusts.

Loans, Credit, Debit and Gift Cards

Receipt of a "loan" will not count as income for the SSI or Medicaid programs, which means that a trust can make a loan of cash directly to a beneficiary. There are rules that must be followed for loans to be valid and non-countable. There must be an enforceable agreement at the time that the loan is made that the loan will be paid back at some point, which usually means that it should be in writing. The agreement to pay back cannot be based on a future contingency such as, "I only have to pay it back if I win the lottery..." Finally, the loan must be considered as "feasible," meaning that there is a reasonable expectation that the beneficiary will have the means at some point to pay back the loan.

If a loan is forgiven, then it would count as income at that time. Also, if the beneficiary still has the loaned amount in the following month, it will then count as a resource. However, school loans are not countable as income or as a resource so long as the funds are spent for tuition, room and board, and other education-related expenses within nine months of receipt.

Since goods or services purchased with a credit card are actually a "loan" that must be paid back to the credit card company, they are also not considered as income to the beneficiary at time of purchase. As long as the beneficiary doesn't sell the goods for cash, there is also the added advantage that the trust can pay back the credit card company without the payment counting as income, except for purchases that are considered as food or shelter. Food and shelter related purchases use the same ISM countable income rules (and particularly the countable income limits) described above.

Use of a debit card by a beneficiary when purchases are made for payment through a trust-funded bank account is income to the beneficiary for the amount accessed. The total amount in the account available to be accessed could possibly be a countable resource. Is a gift card purchased by a trust and provided to a beneficiary considered to be a distribution of income, a line of credit to a vendor (similar to a credit card), or just access for in-kind purchase of goods or services on behalf of a beneficiary by the trust? SSI rules are not yet clear on this point, and it is probable that different Social Security and Medicaid offices will treat the use of debit and gift cards differently until precise guidelines are provided by the agencies. The safe approach is to use them in a very limited way; if they are to be used at all, keep receipts for all special needs items, and be prepared for adverse treatment.

Trust Administration and Accounting

Actual administration of a special needs trust is in most respects similar to administration of any other trust. A trustee has a general obligation to account to beneficiaries and other interested parties. Tax returns may need to be filed (though not always), and tax filing requirements will be based on the tax rules, not special needs trust rules. Some special needs trusts, but by no means all, will be subject to court supervision and control.

Trustee's Duties

As with general trust law requirements, the trustee of a special needs trust has an obligation not to self-deal, not to delegate the trustee's duties impermissibly, not to favor either

income or remainder beneficiaries over one another, and to invest trust assets prudently. The obligations of a trustee are well-discussed in several centuries of legal precedent, and cannot be taken lightly. Legal counsel (and professional investment, tax and accounting assistance) will be required in administration of almost every special needs trust.

A few cardinal trust rules bear special mention:

NO SELF-DEALING

As with other trusts, the trustee of a special needs trust is prohibited from self-dealing. That means no investment of trust assets in the trustee's business or assets, no mingling of trust and personal assets, no borrowing from the trust, no purchase of goods or services (by the trust) from the trustee (other than, of course, trust administration services), and no sale of trust assets to the trustee. The same strictures also apply to the trustee's immediate family members, and the existence of an appraisal, or the favorable terms of a transaction, do not change these rules.

> A trustee has a general obligation to account to beneficiaries and other interested parties. Tax returns may need to be filed (though not always), and tax filing requirements will be based on the tax rules, not special needs trust rules.

IMPARTIALITY

Because the trust has both an "income" beneficiary (the person with disabilities) and a "remainder" beneficiary (the state, in the case of a Medicaid payback trust, or the individuals who will receive assets when the income beneficiary dies), the trustee has a necessarily divided loyalty. It is important to remain impartial as between the trust's beneficiaries. Thus, investment in assets exclusively designed to maximize income at the expense of growth, or vice versa, may violate the trustee's duty to the negatively affected class of beneficiaries. Note that a trust may, by its terms, make clear that the interests of one or the other class of beneficiaries should be paramount—though such language will probably earn the disapproval of the Medicaid agency in any self-settled trust which must be submitted to Medicaid for approval.

DELEGATION

Generally speaking, a trustee may delegate functions but may not avoid liability by doing so. In other words, while the trustee may hire investment advisers, tax preparers and the like, he or she will remain liable for any failures by such professionals.

Some states do limit the trustee's liability. For example, in states which have adopted the Uniform Prudent Investor Act, delegating investment authority pursuant to the Act will limit the trustee's liability so that he or she will only be required to carefully select and monitor the investment adviser.

INVESTMENT

Any trustee should be familiar with the principles of Modern Portfolio Theory, with its emphasis on risk tolerance and asset diversification. A trustee who holds himself, herself, or itself out as having special expertise in investments or asset management will be held to a higher standard, but any trustee will be required to understand and implement prudent investment practices. Some courts will institute an investment policy that requires a percentage of assets to be held in fixed income investments and the remainder in securities (e.g., a 60/40 split is common).

Bond

A trustee, especially one who administers a special needs trust supervised by a probate court, may need to be bonded. Bond is a type of insurance arrangement whereby the trustee pays a premium in order to guarantee that the trustee manages the trust and carries out his or her fiduciary duties correctly. The bond premium is an acceptable expense of the trust, and need not come out of the trustee's own pocket. If the trustee fails to exercise his or her fiduciary duty and the trust loses money as a result, the insurance company that issued the bond will compensate the trust and take action to collect from the trustee.

The bond premium depends on multiple factors, including the credit history of the trustee and the value of the trust. Most corporate trustees are exempt from posting bond. Individual trustees must "post bond"; that is, provide written documentation to the probate court that the individual is bonded. The bond is typically issued for a set period of time, for example one year, and at the expiration of the time period, the trustee must pay an additional premium or show the bond issuer that bond is no longer required by the probate court.

It is possible in most states, at least when the trust is supervised by a court, to ask the court for permission to deposit the assets in a restricted or "blocked" account with a financial institution rather than posting bond. While this circumvents the issue of being bonded, the financial institution should require a certified copy of the court's order authorizing the expenditure of funds prior to making a distribution from the special needs trust. This can result in frequent in-person trips to the bank by the trustee, although it avoids the sometimes costly bond premium.

Titling Assets

The trust assets should not be titled in the beneficiary's name except in limited circumstances, such as when it is advantageous to title the home in the individual's name. Typically, the trust assets should be titled in the name of the

continued on page 14

continued from page 13

trustee. For example, if James Jones is the trustee of the Lisa Martin Special Needs Trust, and that trust was signed on March 15, 2007, then the trust assets should be titled as follows: "James Jones, Trustee of the Lisa Martin Special Needs Trust u/a/d March 15, 2007" ("u/a/d" means "under agreement dated").

It is important that most assets not be held in James Jones's or Lisa Martin's name individually. If the assets are not titled properly, then the assets may be counted as a resource, or the interest earned counted as income, by the agencies that administer means-tested government benefits, which will frustrate the purpose of the special needs trust, as well as contribute to confusion during tax preparation. Additionally, as discussed in further detail below, it may also be important to request a separate Tax ID number for the trust as well as properly title the assets.

Accounting Requirements

A trustee is required to provide adequate accounting information to beneficiaries of the trust. That requirement generally means annual accountings. While there is no specific form required for accountings if the trust is not under court supervision, it is important to provide enough information that a reader could determine the nature and amount of any payment or investment. For some trusts, a simple "check register" accounting may be sufficient, showing interest income and the names of payees, with dates and amounts. Any trust with significant assets or diverse investments, however, should provide a thorough accounting.

> The trustee of a special needs trust is prohibited from self-dealing. That means no investment of trust assets in the trustee's business or assets, no mingling of trust and personal assets, no borrowing from the trust, no purchase of goods or services (by the trust) from the trustee (other than, of course, trust administration services), and no sale of trust assets to the trustee.

Regular, complete accountings are critical. A beneficiary is generally foreclosed from later raising objections to investments or expenditures if he or she received adequate disclosure in the annual accounting at the time. In other words, thorough accounting can limit the trustee's later exposure to claims by beneficiaries, and therefore benefits the trustee.

In addition to the accounting requirements to the beneficiary, the trustee may be required to provide an annual or biennial accounting to the probate court. The trustee should use the county-specific forms available upon request from the court, and may also be required to provide the court with copies of bank statements and cancelled checks or receipts as evidence of trust distributions and deposits. This requires the trustee to be organized or be prepared to pay potentially substantial bank fees for duplicate account statements or cancelled checks.

Reporting to Social Security

The simple term "income" has different meanings in trust accounting, tax preparation, and public benefits eligibility determinations. Trustees sometimes raise concerns that thorough trust accountings (to SSI, especially) may result in suspension of benefits, or that tax return information may be used to terminate SSI or other benefits. While such things undoubtedly do occur, Social Security workers are increasingly likely to be relatively sophisticated about such distinctions, and willing to work through any problems. In a general way, then, it is better to disclose more fully to Social Security rather than withhold any information. Annual accountings of any self-settled trust naming an SSI recipient as beneficiary should be provided to Social Security. Any third-party trust which makes significant distributions for the benefit of an SSI recipient should probably be provided to Social Security, just to prevent later problems that could have been headed off. If distributions disrupt eligibility, the problem is with the distribution, not with the accounting.

If the beneficiary receives only SSDI and not any concurrent SSI, there is no point in providing accounting information to Social Security, because SSDI benefits are not means-tested. If the trust is a third-party trust, the trustee may not have any obligation to provide accounting information, though the beneficiary may (if the beneficiary receives SSI and trust distributions invoke the ISM rules) be required to do so.

Although it no longer occurs as regularly, some Social Security eligibility workers may misunderstand the effect of special needs trust expenditures or terms and reduce or eliminate benefits improperly. When this does occur, it should be possible to remedy the error, but the beneficiary may suffer for months (or years) while the system works out the problem. Far better to head off problems in advance, rather than have to spend substantial resources and time resolving them after the fact. Be aware that fees for a trustee's time spent directly dealing with Social Security on the beneficiary's behalf may be subject to approval by SSA.

Reporting to Medicaid

If the beneficiary resides in a state where the receipt of SSI results in the beneficiary also being automatically enrolled in Medicaid, then no separate accounting requirement need be made to the Medicaid agency. However, if the individual is in a state where SSI and Medicaid are not interrelated, then it

may be necessary to account to both agencies. The Medicaid consumer (or their guardian) is required to notify Medicaid of a change in resources or income within a set period of time, usually as short as ten days. This includes situations where the Medicaid consumer receives an inheritance or settlement and immediately transfers the funds to a special needs trust.

The trustee of a third-party special needs trust may not have the same duty to account, but may choose to provide accounting information to Medicaid rather than risk later disqualification of the beneficiary, even though Medicaid's power to consider trust expenditures may be subject to challenge.

Reporting to the Court

Many self-settled special needs trusts will be treated in essentially the same fashion as a conservatorship or guardianship of the estate. This is so because, typically, the court was initially asked to authorize establishment of the trust. Most courts expect any trust established by the court to remain under court supervision, including bonding, seeking authority to expend funds, and filing periodic accountings.

Even if the trust does not require court accounting, some consideration should be given to seeking court involvement. One great advantage of court supervision of the trust is that each year's accounting is then final as to all items described in that accounting (provided, of course, that the appropriate notice has been given to beneficiaries who might otherwise complain about the trust's administration and other court procedural requirements are followed).

The Court may also have a set fee schedule that governs the amount the trustee can be compensated for providing trust administration services.

Modification of Trust

As explained above, a special needs trust must be irrevocable in order for the trust to be considered an exempt resource. However, that does not preclude the trust itself from permitting the trustee to amend or modify the trust in limited ways, particularly as it relates to program eligibility for the beneficiary. This is particularly important since we cannot predict future changes to the laws governing means-tested benefits. The courts may also be willing to modify or terminate a trust whose purpose has been frustrated by law changes or other factors, such as the trust assets being valued at a nominal amount.

Wrapping up the Trust

If the special needs trust is a self-settled trust with a provision requiring repayment of Medicaid expenses, it will obviously be necessary to determine the "payback" amount upon the death of the beneficiary or termination of the trust. Because Medicaid's historical experience with these trusts is still slight, state agencies may have difficulty providing a reliable and final figure. The prudent trustee will request a written statement of the amount due, including evidence showing how it was calculated and a statement of authority to make the final determination. Once any payback issues have been addressed (and remember that most third-party special needs trusts will have no requirement of repayment to the state), then termination of the trust will follow the usual requirements of tax preparation and filing, final accounting and distribution according to the trust instrument. Remember, because Social Security requires that Medicaid reimbursement and certain tax liabilities must be squared away before the trustee may even pay for the beneficiary's funeral, purchase during the beneficiary's lifetime of an irrevocable pre-paid funeral is critical.

Income Taxation of Special Needs Trusts

Special needs trusts, like other types of trusts, can complicate income tax preparation. The first question to be addressed is whether—for income tax purposes–the trust is a "grantor" trust or not. Tax rules defining "grantor" trusts are neither simple nor intuitive, but fortunately there are some easy rules of thumb to apply, and they will work for most special needs trusts.

"Grantor" Trusts

A "grantor" trust is treated for tax purposes as a transparent entity. In other words, the grantor of a "grantor" trust is treated as having received the income directly, even though the accounts are titled to the trust and all income shows up in the name of the trust.

Generally speaking, a self-settled special needs trust will be a grantor trust if a family member is the trustee. If the trust names an independent trustee it may still be a grantor trust if one of several specific provisions exists in the trust. A qualified accountant or lawyer should be able to tell whether a given trust is a grantor trust at a glance. If it is, it remains a grantor trust for its entire life—or at least until the death of the grantor (when the trust may either terminate or convert into a non-grantor trust as to its new beneficiaries). Until the trust has been reviewed by an expert, assume that it is probably a grantor trust.

It is generally beneficial for a self-settled special needs trust to be a grantor trust. This is true because the tax rates for non-grantor trusts are tightly compressed, and the highest marginal tax rate on income is reached very quickly for trusts. The practical difference will be small if the trust actually makes distributions for the benefit of the beneficiary in excess of its annual taxable income, but the proper tax reporting approach should still be followed.

TAX ID NUMBERS

A grantor trust may, but need not, obtain an Employer Identification Number (an EIN). Some attorneys and accountants choose to secure an EIN in each case, while

continued on page 16

continued from page 15

others resist doing so—either approach is defensible. Although banks, brokerage houses and other financial institutions may insist that the trust requires its own EIN, they are simply wrong. There is widespread confusion about the necessity for an EIN for irrevocable trusts, but a confident and well-informed trustee, attorney or accountant should be able to convince the financial institution that no separate EIN is required. Instead, the trustee can simply provide the financial institution with the grantor's Social Security number.

FILING TAX RETURNS

A grantor trust ordinarily will not file a separate tax return. If a grantor trust has been assigned an EIN, it may file an "informational" return. The return can include a paragraph indicating that the trust is a grantor trust, that all income is being reported on the beneficiary's individual return, and that no substantive information will be included in the fiduciary income tax return. Actually, completing the fiduciary income tax return is not an option for a grantor trust, although again there is much confusion on this point, even among some professionals.

Non-Grantor Trusts

Virtually all third-party, and some self-settled, special needs trusts will be non-grantor trusts. Because income will not be treated as having been earned by the beneficiary, a fiduciary income tax return (IRS form 1041) will be required.

TAX ID NUMBERS

A non-grantor trust will need to obtain its own EIN by filing a federal form SS-4. Nearly all third-party special needs trusts will be "complex" trusts—this designation simply means that the trust is not required to distribute all its income to the income beneficiary each year. Although the trust will be listed as "complex" on the SS-4, it may in fact alternate between "complex" and "simple" on each year's 1041.

FILING TAX RETURNS

The non-grantor trust must file a 1041 each year. All distributions for the benefit of the beneficiary are conclusively presumed to be of income first, so any trust expenditures in excess of deductions will result in a Form K-1 showing income imputed to the beneficiary. This should not cause particular concern, since Social Security (and even Medicaid) eligibility workers are increasingly likely to understand that "income" for tax purposes is different from "income" for public benefits eligibility purposes. Any tax liability incurred by the individual beneficiary as a result of this imputation can be paid by the trust, though the trustee may not have the authority to prepare and sign the individual's tax return.

Administrative and other deductible expenses on an individual tax return must reach 2% of the taxpayer's income before being deducted at all. The same is not true of a trust tax return, leading to a modest benefit to treatment as a non-grantor trust in some cases. This benefit may not offset the compressed income tax rates levied against non-grantor trusts, but each case will be different. The difficulty in determining the proper—and the best—income tax treatment is made worse when one adds the confusing option of treatment as a "Qualified Disability Trust."

Qualified Disability Trust

Beginning in 2002, Congress allowed some non-grantor special needs trusts to receive a modest income tax benefit. Trusts qualifying under Internal Revenue Code Section 642(b)(2)(C) receive a special benefit—they are granted a larger and special deduction on their federal income taxes. In tax year 2023 (that is, the taxes that will be paid in April, 2024) for example, a Qualified Disability Trust can deduct $4,700 before any tax payment is due. That figure is slated to increase each year. Once the trust deducts that amount from its income, any remaining income might then be passed through to the beneficiary's tax return; the beneficiary may well pay no tax, or a very low rate of tax.

Coupled with the greater flexibility available to non-grantor trusts in deducting administrative expenses, Qualified Disability Trust treatment may be advantageous in some cases. Typically, the Qualified Disability Trust election will be attractive when there is a fair amount of income on trust assets, and relatively few medical or other expenses incurred on behalf of the beneficiary. Careful review with a qualified income tax professional is usually necessary to determine whether to pursue Qualified Disability Trust treatment.

Seeking Professional Tax Advice

It should be apparent from this brief discussion of taxation of special needs trusts that professional tax preparation and advice are essential. Although most accountants are qualified to prepare fiduciary (trust) income tax returns, most do not have much experience in the field. A first question to ask a prospective accountant might be "How many 1041s do you typically prepare in a year?" Follow that with "Could you please explain the concept of Qualified Disability Trusts to me?" and you will quickly locate any truly proficient practitioner. You probably will not want to automatically reject an accountant who cannot tell you about Qualified Disability Trusts immediately, unless you are prepared to deal with an accountant in another city—there are simply not very many accountants or tax preparers who have ever had occasion to claim that status on any fiduciary income tax return. As always, you can get some assistance in complicated special needs trust issues from the attorney who prepared the document, or the attorney who advises you as trustee. Members of the Special Needs Alliance® are usually among the very few who are familiar with these concepts, and your attorney may have worked with an accountant in your area who is familiar with the special tax treatment of these trusts.

For Further Reading

There are a handful of books and articles, and a growing number of websites, available to aid trustees of special needs trusts. Among our favorites:

Special Needs Trust Administration Manual: A Guide for Trustees, by Jackins, Blank, Macy and Shulman—this guide is among the best available. It was written by four Massachusetts lawyers, and is frankly focused on Massachusetts law and practice. Much of what the authors have to say, however, is applicable to special needs trusts in every state.

Special People, Special Planning: Creating a Safe Legal Haven for Families with Special Needs, by Hoyt and Pollock—provides some general advice and direction, but is more conversational than detailed. This volume also tends to focus on the "why" more than the "how", which is an important message but not as useful to someone who is already administering a special needs trust.

Special Needs Trusts: Protect Your Child's Financial Future, by Elias—this recent addition to the literature comes from Nolo Press, an organization that many lawyers find annoying at best. We disagree. This is a plain-language, straightforward explanation of special needs trusts from a lawyer who doesn't even practice in the area (his previous books for Nolo Press include explanations of bankruptcy, trademark and other areas of law).

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