Planning For Individuals With Disabilities: Special Needs Trusts

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SPECIAL NEEDS TRUSTS are means for persons with disabilities to qualify to receive government benefits from needs-based programs while having access to additional funds to pay for supplemental expenses not covered by the government benefits. The beneficiary of a properly structured special needs trust will not lose eligibility for the government benefits due to excess assets or income. The opportunity for creating a special needs trust may arise in many different contexts. Examples include a parent who wishes to provide for a disabled child's long-term financial needs in his or her will; a personal injury settlement; or when a person with significant assets becomes disabled and wants to qualify for needs-based government benefits without first spending down his or her own assets.

SELF-SETTLED VERSUS THIRD-PARTY-SETTLED SPECIAL NEEDS TRUSTS • Special needs trusts fall under two general categories: self-settled and third-party settled. The fundamental difference between the two types is whose assets are used to fund the trust. A self-settled special needs trust is funded with the disabled individual's own assets, while the third-party-settled special needs trust is funded with the assets of someone other than the disabled individual.

The tax implications of special needs trusts differ depending on whether the trust is self-settled or third-party settled, but in either case, a practitioner must consider both income and transfer tax issues in creating, funding, and administering the trust.

NEEDS-BASED GOVERNMENT BENEFIT PROGRAMS • Some government benefit programs are limited to low-income individuals. These programs are often known as "needs-based," "asset-sensitive," or "means-tested" programs. To qualify for benefits under a needs-based program, the individual must, in addition to meeting other eligibility criteria, meet financial eligibility criteria. In particular, a person must generally not have countable assets "available" to him or her in excess of the specified level. Additionally, the individual's monthly income must also fall below that program's threshold level.

It is important to point out that needs-based government benefit programs generally only count certain assets toward the asset eligibility amount ("countable assets"). Non-countable assets may include, for example, a residence, a car, or a burial fund. Likewise, certain amounts of income are often exempt from the income level requirement.

Two common examples of needs-based government benefit programs for low-income persons with disabilities are Supplemental Security Income and Medicaid.

Supplemental Security Income (SSI)

The Supplemental Security Income (SSI) program, administered by the Social Security Administration (SSA), provides monthly payments to low-income individuals 65 and over and low-income persons under 65 who are disabled. 42 U.S.C. §§1381-1383. For SSI purposes, the general definition of disability is that the individual is unable to engage in any substantial gainful activity.

SSI eligibility also requires that the individual's counted income and assets are below certain maximum levels. The SSI maximum monthly income levels differ by state, and not all of an individual's income is counted (e.g. the first $20 of most types of income, and the first $65 and half of the excess over $65, of wages are generally not counted toward the monthly income eligibility amount).

The asset cap for counted assets is $2,000 per individual or $3,000 per couple. However, some assets do not count toward this cap, including the individual's home, car, insurance policies with a face value of $1,500 or less, burial plots, and burial funds.

Medicaid

Medicaid is another common needs-based program, which provides health insurance for low income elderly and disabled individuals. Medicaid is jointly funded by state and federal governments. Each state administers its own Medicaid program, but those programs must comply with federal rules.

The eligibility requirements vary from state to state, but are all based on the same basic framework with both an asset and income eligibility standard. In most but not all states, recipients of SSI automatically qualify for Medicaid benefits. 42 U.S.C. §1396 *et seq*. It is important to review the specific eligibility rules for the state in which the disabled beneficiary resides.

Other Needs-Based Programs

There are many other federal and state needs-based government benefit programs, which may have similar asset and income eligibility standards. In determining the appropriateness of a special needs trust, it is important to determine whether the benefits that the individual is currently receiving or may in the future receive are needs-based.

DEFINITION OF "AVAILABLE" • It is important to understand that the countable assets for Medicaid and SSI eligibility include only those assets that are deemed "available" to the disabled individual. The fundamental principle behind a special needs trust is to make the trust assets "unavailable" to the disabled individual, so that they do not count toward the means determination. For example, assets are "available" to an individual for

SSI purposes "[i]f the individual has the right, authority, or power to liquidate the property or his or her share of the property….If a property right cannot be liquidated, the property will not be considered a resource of the individual." 20 C.F.R. §416.1201(a)(1).

NON-NEEDS-BASED GOVERNMENT BENEFIT PROGRAMS • In determining the type of benefits an individual is currently receiving it is generally advisable not to rely solely on the client's self-reporting, particularly because many of these benefit programs have similar sounding names. For instance, two non-needs-based government benefit programs that provide benefits to disabled individuals are Social Security Disability Insurance (SSDI) and Medicare, which may be easily confused with SSI and Medicaid.

SSDI (compare SSI) pays a monthly benefit to disabled individuals with sufficient work history. Medicare (compare Medicaid) provides health benefits to persons aged 65 or older and entitled to receive Social Security Retirement benefits, or under age 65 who receive SSDI benefits for at least two years.

If an individual is receiving only non-needs-based benefits, and is likely to continue receiving only those benefits, a special needs trust may be unnecessary.

SUPPLEMENTAL NEEDS • Government benefit programs like SSI and Medicaid provide for an individual's basic needs of shelter, medical care, and food. These programs do not provide for all of an individual's supplemental needs, and these supplemental needs are generally what the special needs trust distributions are used to pay for. Examples of supplemental needs include transportation, reading materials, entertainment, and the like.

SELF-SETTLED TRUSTS • The first general type of special needs trusts are self-settled special needs trusts, which are funded with the disabled beneficiary's own assets, rather than the assets of a third-party. Self-settled special needs trusts present policy issues in that they allow individuals to avoid spending down their own assets before qualifying for needs-based government benefits. Federal law provides two types of self-settled special needs trusts that allow the preservation of a disabled individual's assets while rendering those assets "unavailable" and thus not counted in determining eligibility for SSI and Medicaid: "(d)(4)(A) trusts" and "pooled trusts."

It is important to note that trusts are only explicitly functional for sheltering assets for Medicaid and SSI benefit eligibility purposes. Other needs-based government benefit programs often do not recognize these trusts as an effective way to shelter assets and may impute the trust income to the disabled individual for a period of time.

"(d)(4)(A) Trusts"

One type of self-settled special needs trust to preserve Medicaid and SSI eligibility is found in subsection (d)(4)(A) of 42 U.S.C. §1396p, hence the name. A (d)(4)(A) trust must be created for the sole benefit of a disabled individual under 65 and established by the individual's parent, grandparent, legal guardian, or the court. It is important to note that although the (d)(4)(A) trust is *established* by someone other than the disabled individual, it is considered a "self-settled trust" because it is funded with the disabled individual's own assets, rather than the assets of a third party. This terminology can be confusing because it differs from the general use of the term "self-settled."

The SSA's Program Operations Manual System (POMS) makes it clear that the (d)(4)(A) trust may not be established by the disabled individual herself and that the person establishing the trust must have the authority to act with respect to the disabled individual's assets. POMS SI 01120.203. This requirement can be problematic in establishing a (d)(4)(A) trust for a disabled individual who is competent. To solve this issue, practitioners generally often have the parent or grandparent establish the trust and fund it nominally with their own assets, then the disabled individual transfers her own assets to the trust. Alternatively, the disabled individual could grant the parent or grandparent authority to transfer her assets to the trust through a power of attorney, so that the parent or grandparent can both establish and fund the trust with the disabled beneficiary's own assets.

The trustee of the (d)(4)(A) trust can be a family member. However, it is often preferable to have a professional trustee, either acting alone or in conjunction with a family member.

The trust must also provide that upon the earlier of the disabled individual's death, the end of the beneficiary's disability, or the termination of the trust, the remaining trust assets will be used to "pay back" the state up to the amount paid under the Medicaid program for the disabled person's care.

Pooled Trusts

Another type of self-settled special needs trust is a "pooled" trust. 42 U.S.C. §1396p(d)(4)(C). A pooled special needs trust is a trust created and administered by a nonprofit organization. Many different disabled individuals' assets are contributed to the trust, and the assets of each beneficiary are maintained in a separate account. Upon the disabled beneficiary's death, if the account's funds have not been exhausted, the funds must either stay in the pooled trust for the benefit of the other trust beneficiaries, or they must be used to pay back the state up to the amount expended for the beneficiary's care. Because the assets of many beneficiaries are pooled for investment and management purposes, pooled trusts can be advantageous, particularly for disabled individuals with relatively modest assets to contribute to the special needs trust.

State-Specific Rules

Some states have adopted specific statutes or rules regarding additional requirements for (d)(4)(A) and pooled trusts, so it is important to check the specific requirements for the state in which the disabled beneficiary resides. Consider including a provision authorizing the trustee to amend the trust to conform to changes in the law and rules for your states, or to conform to the rules of another state, if the beneficiary moves.

Only The Disabled Individual Should Contribute To A Self-Settled Special Needs Trust

Because the self-settled (d)(4)(A) or pooled special needs trusts are subject to a payback requirement, friends and family members should not contribute assets to it. If friends and family of the disabled individual wish to make contributions for the benefit of the disabled individual, it may be appropriate to form a separate third-party-settled special needs trust to which they can contribute.

TAX CONSIDERATIONS UPON FUNDING THE SELF-SETTLED SPECIAL NEEDS TRUSTS • Although this is a controversial issue, there are transfer tax considerations upon funding a self-settled special needs trust that are worth considering. In particular, because the (d)(4)(A) trust must be irrevocable, there are some arguments that the disabled individual may be making a completed gift upon funding the trust which may be subject to gift tax.

A completed gift occurs when the donor gives up dominion and control over the assets. Treasury Reg. 25.2511-2(b). To the extent the disabled individual has contributed assets to an irrevocable special needs trust and given up dominion and control over the property, the action could arguably be a completed gift. If so, the question is then, to whom is the gift being made?

A common response is that because the disabled individual is funding a trust for his or her own benefit, there is simply no taxable gift being made. It is possible that the gift is being made to the remainder beneficiaries of the trust, in which case it is very difficult to value.

Other commentators argue that funding a self-settled special needs trust is not a completed gift, because the disabled individual is not truly giving up dominion and control over the assets. For example, because the disabled individual has the power, through court review, to ensure the trust is used for his or her benefit, there remains some amount of control over the assets.

Some practitioners avoid the potential problem altogether by drafting the trust so as to prevent its funding from being a completed gift. This can be achieved, for example, by having the individual retain a testamentary power of appointment over the remainder left after the state is paid back for Medicaid benefits. In that case, the trust assets remaining at the disabled beneficiary's death will be includable in his or her estate under IRC §2038 due to the retention of a testamentary power of appointment. In many cases, whether the trust is includable in the disabled individual's gross estate for estate purposes will be of little concern because the amount of assets remaining at the individual's death will be below the threshold for estate tax purposes.

INCOME TAX TREATMENT OF SELF-SETTLED (D)(4)(A) SPECIAL NEEDS TRUSTS • For a self-settled (d)(4)(A) special needs trust, it is generally preferable to qualify the trust as a grantor trust in order to have the income taxed at the beneficiary's lower effective personal rate. However, the decision regarding whether it is most advantageous to have the trust taxed as a grantor trust or subject to tax under the trust rules must be made after a careful review of the particular situation.

Grantor Trust Status

The owner of all or a portion of a trust is taxed on all items of income attributable to the portions of the trust of which the person is treated as the owner. IRC §671. Any portion of a trust that is not treated as owned by the grantor or another person is taxed under the normal trust rules in IRC subchapter J, subparts A-D.

Generally, if someone is currently entitled to all of the income from the trust, he or she will be treated as the owner, but in a (d)(4)(A) trust, no one is currently entitled to all the income of the trust. A (d)(4)(A) trust's income will be taxed at the trust level, unless the trust is treated as a grantor trust. Under the grantor trust rules, if the grantor retains certain rights or powers under IRC §§671-677, the grantor is treated as the owner of the trust and the income is taxed to the grantor. These powers are, generally:

- A reversionary interest in either the corpus or the income, if the value of that interest is more than five percent of the value of the trust when created (IRC §673);
- A power to control the beneficial enjoyment of either the corpus or the income, without an adverse party's consent (IRC §674);
- Various administrative powers, exercisable by the grantor or a non-adverse party, without the consent of an adverse party, including: the power to purchase, exchange, or otherwise deal with or dispose of the corpus or income for less than adequate consideration (IRC §675(1)); the power to borrow the trust assets without adequate interest and security (IRC §675(2)); actually borrowing trust assets without adequate security and without repayment within the taxable year (IRC §675(3)); and certain other administrative powers exercisable in a non-fiduciary capacity (IRC §675(4));
- A power to reacquire the corpus by substituting assets of an equivalent value (IRC §675(4)(C);

- A power to revoke the trust or return the trust corpus to the grantor (IRC §676); and
- A power to distribute income to or for the benefit of the grantor or to accumulate income for future distribution to the grantor (IRC §677).

In determining whether a self-settled special needs trust receives grantor trust status, first identify the grantor. For IRS purposes, the grantor is the person who funds the trust, not necessarily the person who forms the trust. See Treas. Reg. §1.671-2(e)(1). Thus, if the trust is formed by someone other than the disabled individual, such as is the case with a (d)(4)(A) trust which cannot be established by the disabled individual, the trust may still qualify as a grantor trust because the disabled individual's assets are used to fund the trust.

If grantor trust status is desired, the (d)(4)(A) trust should be drafted to specifically invoke the grantor trust rules, by retaining for the grantor one or more of the powers contained in IRC §§671-677 that give rise to grantor trust status for income tax purposes. Be careful not to include a power that would cause the assets to be deemed "available" to the disabled individual. Two common powers used in the (d)(4)(A) trust context are the power "to reacquire the trust corpus by substituting other property of an equivalent value," under IRC §675(4)(C), and the power to distribute the trust income to the grantor or accumulate it in the discretion of a non-adverse party, under IRC §677.

Non-Grantor Trust? Qualified Disability Trust

Although historically (d)(4)(A) trusts have generally been drafted as grantor trusts, in some circumstances it may be preferable for the trust to be a "qualified disability trust." A qualified disability trust is a non-grantor trust that qualifies as a "disability trust described in subsection (c)(2)(B)(iv) of section 1917 of the Social Security Act (42 U.S.C. 1396p)" and whose beneficiaries are all considered disabled under the Social Security Act for some portion of the year. IRC §642(b)(2)(C). A qualified disability trust is allowed a deduction in the amount of the exemption under IRC §151(d) (personal exemption deduction) for an unmarried individual with no dependents. The decision of which tax treatment is best—grantor or non-grantor—must be made on a case-by-case basis.

THIRD-PARTY-SETTLED SPECIAL NEEDS TRUSTS • The second general type of special needs trusts are third-party-settled special needs trusts, which are trusts created by and funded with the assets of someone other than the disabled beneficiary. These trusts are often called "supplemental needs trusts" because they generally exist to provide for the disabled beneficiary's supplemental rather than basic needs. Third-party special needs trusts are not governed by the same rules that govern self-settled special needs trusts, and are thus not subject to the payback requirements of the (d)(4)(A) and pooled trusts. Third-party-settled special needs trusts are often testamentary trusts, but may be created during the settlor's life as well.

A very common form of third-party-settled special needs trust is a wholly discretionary trust for the benefit of the disabled beneficiary. By the terms of the trust, the trustee has total discretion over whether or not to make distributions, and in what amounts. The assets and income of a wholly discretionary third-party-settled trust will not be "available resources" to the disabled beneficiary, because he or she has no right to compel a distribution. Any distributions actually made to the disabled beneficiary, however, could affect the disabled individual's eligibility for needs-based government benefits, and so careful attention must be paid to the potential consequences of a distribution.

Some practitioners prefer to draft more restrictive distribution standards into the trust. In particular, many practitioners use standards like "special needs only" and expressly prohibit distributions for basic needs such as food, clothing and shelter.

Some states have particular rules requiring specific distribution standards, so it is important to check the rules of the state in which the beneficiary lives to comply with its rules.

Drafting Third-Party-Settled Special Needs Trusts

There are some important guidelines to keep in mind when drafting third-party-settled special needs trusts. First, it must be a discretionary trust, giving the trustee discretion over distributions. Avoid giving the trustee a broad ascertainable standard for distributions like health, maintenance, education and support, because these standards will likely make the trust "available" to the beneficiary to the extent that distributions could be made under these standards. It is also advisable not to use the term "support" in describing the purpose of the trust or distributions (e.g. do not give the trustee discretion to make distributions "for the beneficiary's support"), because government benefit program administrators may find that the trust is for the disabled beneficiary's basic support, rather than for supplemental needs.

Second, although special needs trusts commonly explicitly prohibit distributions that would have the effect of reducing or eliminating government benefits, this limitation may have undesirable consequences. In some cases it may be desirable for the trustee to have discretion to make distributions that have the effect of temporarily reducing or eliminating benefits, when the net effect of the distribution would be beneficial to the individual. Again, confirm that the rules for the state in which the disabled beneficiary resides do not require third-party-settled special needs trusts to prohibit such distributions.

Third, the trust should always have a spendthrift provision. In addition to affording creditor protection for the trust assets, these provisions are often looked for when the trust is reviewed for benefits eligibility purposes.

Fourth, the disabled beneficiary should not have control over the trust. For example, do not give the beneficiary the power to remove a trustee, compel distributions, or terminate the trust.

GIFT TAX AND THIRD-PARTY-SETTLED SPECIAL NEEDS TRUSTS • Contributions to a third-party-settled special needs trust are not completed gifts of a present interest, thus they will not qualify for the annual gift exclusion (e.g. $12,000 in 2008). It is very important to note that the common method by which gifts in trust are qualified for annual exclusion treatment, *Crummey* withdrawal rights, are not appropriate in the special needs trust context and should never be given to the disabled beneficiary of a special needs trust.

If the disabled beneficiary has a Crummey withdrawal right, those assets will be "available" to the disabled individual to the extent the funds could be withdrawn by the beneficiary, negating the effectiveness of the special needs trust. Additionally, the Crummey power would likely have the undesirable effect of converting the trust to a self-settled trust: when the disabled beneficiary allows the withdrawal power to lapse, he or she would likely be making a gift to the trust. Because that gift would not be a gift of a present interest, it would also not qualify for the annual exclusion. Thus, the inclusion of Crummey withdrawal rights for the disabled beneficiary would negate the effectiveness of the special needs trust and must be avoided.

INCOME TAX TREATMENT • The income tax treatment of a third-party-settled special needs trust will depend on whether or not the trust is treated as a grantor trust. Remember that the grantor in this case is the third-party creating and funding the trust, not the disabled beneficiary.

In general, most third-party-settled special needs trusts will not qualify as grantor trusts and will be taxed under the trust income rules in IRC §§641-692. For example, a testamentary third-party-settled special needs trust, one created in the grantor's will, will not generally qualify as a grantor trust because the grantor has not retained any of the specified rights or powers in IRC §§671-677. Although the compressed income tax brackets for trusts may yield a higher effective tax rate at the trust level for the retained trust income than the rate for an individual, careful attention must be paid to determine the net effect of making distributions to avoid the tax on trust income at the trust rates.

If a third-party-settled special needs trust is created as an intervivos trust (while the grantor is alive), there are some instances where it may be preferable for the trust income to be taxed to the grantor. In that case, the trust should be drafted as an "intentionally defective grantor trust" to specifically invoke the grantor trust rules by retaining for the grantor one or more of the powers contained in IRC §§673-677 that give rise to grantor trust status, while avoiding inclusion of the trust's assets in the grantor's estate. A common way to do this is to retain for the grantor, or a non-adverse party, the power to reacquire trust assets by substituting assets of equivalent value (often called a "swap power"). IRC §675(4)(C). The swap power will trigger grantor trust treatment of the trust income for income tax purposes, but will not, in itself, cause the trust to be includable in the grantor's gross estate for estate tax purposes.

CONCLUSION AND TAKE-AWAYS CHECKLIST • Special needs trusts present important planning opportunities. When properly structured, special needs trusts may significantly improve the quality of life of a disabled individual who receives needs-based government benefits by providing for supplemental needs that the government benefits do not.

When faced with planning for a disabled individual it is important to determine:

- From which government benefit programs is the individual currently receiving or likely in the future to receive benefits? Be sure to collect accurate information and not to rely solely on information provided by the client.
- Are these needs-based programs? If so, then a special needs trust might be appropriate. Remember that the specific eligibility standards may differ from state-to-state, so be sure to check the requirements for the state in which the disabled individual resides.
- Whose assets would be used to fund the trust—the disabled individual's or a third-party's?
- If the disabled individual's assets will be used to fund the trust, how much does the individual have with which to fund the trust? If the assets are significant, a (d)(4)(A) trust may be worthwhile, otherwise a pooled trust may be most cost-effective.
- Consider the best tax treatment of a (d)(4)(A) trust for your particular situation. If grantor trust status is desired, be sure to include a right or power that does not conflict with the SSI or Medicaid rules regarding availability.
- Do not allow friends and family members to make contributions to self-settled special needs trusts, because these trusts have payback requirements that third-party-settled special needs trusts do not. If friends and family members wish to make contributions to a special needs trust, consider forming a third-party-settled special needs trust in addition to a self-settled trust.
- If a third-party's assets will be used to fund the trust, what distribution standards should be used? Most states allow for wholly discretionary special needs trusts, but some states require specific distribution standards, so be sure to confirm the rules for the disabled individual's state.

- If the third-party-settled special needs trust will use a distribution standard, consider *not* prohibiting any distribution that would have the effect of reducing or eliminating eligibility for government benefits to give the trustee greater discretion to make distributions in the best interest of the beneficiary.
- Gifts to third-party-settled special needs trusts will not qualify as gifts of present interests for annual exclusion purposes. However, *do not* grant the disabled beneficiary *Crummey* withdrawal powers, because the trust assets subject to the *Crummey* rights will generally be "available" to the disabled beneficiary.
- Carefully consider whether a professional trustee, acting alone or in conjunction with a family member, is appropriate. Special needs trusts can require careful attention to ensure that the distributions have a net positive effect to the disabled beneficiary. Never have the disabled individual serve as trustee.
- Include a provision to allow the trustee to modify the trust to comply with changes in the law or to comply with another state's rules, if the beneficiary moves.