SPECIAL NEEDS TRUSTS
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Section 1. What is a Special Needs Trust and why might your client need one? Fo

A special or supplemental needs trust (SNT) enables its disabled beneficiary to enjoy the benefit of private wealth without foregoing the use of government benefits originally intended for the poor. This commingling of private wealth and public benefits is not as bizarre as may appear. Rarely is either alone sufficient to meet the lifetime needs of a disabled person. Denying public benefits where there is some private wealth in the background would, in this view, only result in pauperization that would be bad public policy without, at the same time, actually saving significant costs.

But securing public benefits is only a means to the larger end of enabling the disabled beneficiary to live as pleasant and comfortable a life as the available means, and his or her own limitations, permit. The SNT has to be drafted to avoid the risks and problems that those limitations create and to provide as much assurance as possible that the trustees – who may serve for many decades beyond the life of the creator – will not lose sight of those goals nor fail to use all available means. And of course funding decisions should be made with a clear eye as to what can or cannot be achieved.

The terms "special" and "supplemental" – describing the needs these trusts meet – do not have precise meaning and are as a practical matter interchangeable. They do not appear in any organic or authorizing statute, although now they may be used in regulations to identify their subjects or targets. The notion of "supplemental" is that the trust is "to supplement, not supplant," public benefits. The word special is probably drawn from special education, which often serves the same public. While special education refers to specific, enhanced teaching services, an SNT often meets basic needs such as food, shelter and transportation while the beneficiary gets special services available through public benefits.

Medicaid, is the means-tested public benefit most often sought in using an SNT. The disabled people who need and might, with appropriate planning, qualify for Medicaid can roughly be put into two groups: those with no other health insurance and those with needs for which conventional health insurance is inadequate. Medicare, state health insurance plans, and other traditional health insurance rarely provide long-term institutional or residential care services, the very thing disabled individuals often need if they are to avoid repeated and perhaps extended hospitalizations. Through "waiver" programs, state Medicaid programs provide "assisted living facilities (ALFs), qualified residential treatment facilities (RTFs) and adult family-care homes (AFCHs) ... [to] promote and maintain the health of eligible recipients in order to delay or prevent institutionalization."

Section 2. – The public benefits background.

Given that means-tested public benefits programs are SNTs' ***raison d'etre***, no one should embark on the use of an SNT without understanding the primary means-tested public benefits programs for disabled individuals and how they relate to each other and to public insurance programs for the disabled that are not means-tested. All of these programs are vast, implemented through volumes of regulations, both state and federal, with major treatises devoted to explaining them. The following discussion can be no more than the merest pass over the aspects of the programs that are of fundamental importance to SNT work and the disabled beneficiaries of those trusts.

There are two main cash benefit programs for the disabled, each associated with a medical care program. The cash benefit programs are Social Security Disability Insurance (SSDI) and Supplemental Security Income (SSI). Their respective medical benefit programs are Medicare and Medicaid. Congress probably did not intend to cause perpetual confusion between the pairs of programs by giving them such similar names that even experienced practitioners have been known to mis-state the program they mean from time to time. Congress authorized the use of SNTs to facilitate eligibility for Medicaid

and SSI specifically; there are other means-tested public benefits programs where an SNT may sometimes assist the beneficiary in getting eligibility.

Income or cash benefits

► ***Social Security Disability Insurance:*** SSDI provides cash benefits for disabled workers and the disabled dependents and survivors of workers who qualify for benefits.

A disabled person is entitled to benefits based on his or her own record if he or she worked in five out of the ten years before the onset of disability or, for a younger worker, if he or she has worked more than half of the time since turning 18, but at least a year and a half.

A person who became disabled before turning 22 years old can get benefits based on a parent's eligibility, but eligibility only begins when the parent has died or is him or herself getting Social Security benefits because of retirement or disability. The parent can get retirement benefits if he or she worked ten years in their lifetime and paid FICA taxes; he or she can retire, getting reduced benefits, beginning at age 62, or take regular retirement with full benefits at age 66.

Since SSDI is intended to replace income earned from work, the test for disability is whether the person is unable to work. It provides a basic, no-frills benefit. Unlike some private disability insurance, for example, SSDI is based on the inability to do ***any*** work in the "national economy," not the work that the person was doing prior to disability.

SSDI benefits are not means-tested. No matter how wealthy a person is nor how much other income a person has, SSDI benefits are earned and the amount is not affected by wealth or other income, although too much earned income would indicate the person was no longer disabled.

► ***Supplemental Security Income:*** Supplemental Security Income (SSI) is a basic, very modest income benefit for the disabled (as well as the aged) poor, up to $674 per month (the "federal benefit level") in 2011. SSI was established in 1972 to replace the existing patchwork of state welfare programs. It uses the same employment-related test for disability as Social Security.

It is means-tested. Recipients are not allowed to have more than $2,000 in non-exempt assets, referred to as resources. The most significant exempt assets are the home in which the person lives or, if absent, to which he intends to return, household goods, and one automobile.

There is no income test as a practical matter, but the amount of a person's SSI benefit is based on his or her other income. For SSI purposes, income is "cash or in-kind [items] that can be used to meet his or her need for food or shelter." The benefit is designed to raise a beneficiary's income to the federal benefit level, subject to certain small exclusions and set-asides. Thus, a person who has income from another source, such as SSDI, gets only enough from SSI to raise his or her income to the federal benefit level. Cash distributions from an SNT to a beneficiary getting SSI would reduce the beneficiary's income dollar-for-dollar for each dollar distributed. Beyond that, three rules govern how SSI treats financial support from others, including SNTs.

First, with one important exception, payments to another for the benefit of an SSI beneficiary are not treated as income to the beneficiary for SSI purposes. This includes payment for goods and services for the beneficiary, as well as credit card or other credit payments. As long as the beneficiary does not get something he or she can convert to cash, it is not SSI-type income. (Money borrowed, such as a cash advance on a credit card, is not income, although it might become a resource.) But note that something that might be converted to cash, like some gift or cash cards, or in the days before the Patriot Act, airline tickets paid for with cash, were treated as income when received, reducing the SSI benefit, until Congress intervened.

Second, the important exception to the general rule about third-party payments is that ***any*** payment for food or shelter for a beneficiary is income to the beneficiary for SSI purposes. This is called in-kind support and maintenance (ISM).

Third, SSI assumes that ISM is worth only one-third of the federal benefit level plus $20 under the "presumed maximum value rule"(PMV) but the beneficiary can prove it is less. Whether the SNT

pays $300 or $1,000 rent per month for a beneficiary's apartment, the result is a reduction in benefits (in 2011) of only $225, one third of the current benefit of $674.

Finally, to a limited extent SSI views finances from the perspective of the family. The income and resources of the parent of a minor child living with the parent are "deemed" to be available until the child turns 18. Conversely, however, there is no deeming when the child turns 18 even if he or she continues to live in the parents' home; then, only the ISM rule governs the benefit of living with the parents.

Medical benefits.

The medical benefit programs are associated with the cash benefit programs, but are not co-terminous: not all SSDI beneficiaries get Medicare, and not all Medicare beneficiaries get Social Security benefits, and not all SSI beneficiaries get Medicaid, and not all Medicaid beneficiaries get SSI.

► ***Medicare:*** Medicare, the federal health insurance program operated by CMS through private fiscal intermediaries, provides hospital (Part A), physician and other medical (Part B), and drug (Part D) benefits for disabled workers and the disabled dependents and survivors of deceased or retired workers, paid for through a combination of general revenue and payroll taxes and premiums paid by enrolled insureds.

Disabled individuals getting SSDI benefits, either on their own records or as disabled adult children, at age 18 or above can get Medicare, but only after a statutory two-year waiting period. This limitation bears emphasis: The 18-year-old disabled child cannot get SSDI, and thus Medicare, until one parent insured under Social Security has died or qualified for Social Security benefits him or herself, either through retirement or disability.

► ***Medicaid:*** Medicaid provides a broad range of medical and remedial goods and services, with substantial variation from state to state, and many long-term care services quite unlike and beyond those provided by conventional medical insurance, including Medicare.

Thirty-one states and D.C. provide Medicaid to all SSI beneficiaries ("SSI states"); the remaining states provide Medicaid to those who meet the requirements of their state Medicaid program as it existed on January 1, 1972. In addition, SSI states are required or allowed to provide Medicaid in other categories, often with higher income standards than SSI or for those whose medical costs are high relative to their income ("medically needy"). Where the states must or do expand coverage, they must in general use the same methodologies as SSI for determining Medicaid eligibility ("comparability"). They can be more, but not less, generous.

Automatic eligibility for Medicaid through SSI is significant. First, it simplifies the application process. Not only is there a single and relatively simpler application, but eligibility is simpler. Those eligible only as "medically needy" – because their medical expenses are high compared to income, which is too high for SSI – must re-establish eligibility every six months. Each state has a "medically needy income level" (MNIL); individuals get benefits only when their medical expenses incurred during a six-month period, subtracted from their projected income during that period, leaves them with less than the MNIL. For those who must live that way, scheduling medical appointments not covered by Medicaid (but deductible in determining whether they are "medically needy") is a high art. Second, and more significant, SSI/Medicaid eligibility is more generous. The MNIL is often less than the SSI benefit level, so that a person might get Medicaid benefits only after his or her medical expenses use up all but $350 per month (the MNIL) of their available income.

The interplay of SSI and Medicaid is vastly complicated, with hidden traps for the unwary and with hidden benefits for the well-informed. For example, a disabled adult child living with his parents might qualify for SSI benefits at age 18, when his or her parents' income and resources are no longer "deemed" available to him, and thus also qualify for Medicaid. The child might become eligible for SSDI when a parent dies or retires, based on the parent's record, and would lose SSI and thus automatic Medicaid eligibility but for some special provisions that disregard SSDI (but not other income) or SSDI

cost of living increases in continuing Medicaid eligibility. On the other hand, if the child began getting SSDI (and not SSI) at age 18, these provisions would not help them to get Medicaid.

Other benefit programs

There are other federal and state benefit programs that might affect the beneficiary of an SNT, many means-tested, not all addressing specifically whether a Medicaid/SSI compliant SNT is to be disregarded as it is with Medicaid and SSI. Given the importance of shelter, the review here is limited to Federal housing benefits, but anyone undertaking to serve as an SNT trustee should familiarize him or herself with others.

"Section 8," as it is widely known, provides rental assistance for low-income families and individuals. Like Medicaid, it is a federal program administered through the states (in this case public housing agencies), so that it also has state-to-state and area-to-area variation interpreting the same federal law. Eligible families get vouchers that a landlord of an approved facility can submit for partial payment of rent. The value of the voucher and the percent of income that the family pays are based on an income standard that varies with family size and geographical area.

There is no asset test, ***per se***, nor a strict anti-transfer rule, but income is imputed to assets owned by family members and in the case of transfers (including transfers to an SNT), imputed for two years after the transfer. Generally all receipts, including in-kind benefits and distributions from SNTs, are income unless specifically excluded, although one exclusion is for groceries provided by "persons not living in the household." "Temporary, nonrecurring, or sporadic income (including gifts) is <u>not counted</u>," but even annual distributions may be considered recurring and therefore included.

An unusual but permissible strategy is for the home owned by an SNT to qualify as the landlord to get payment pursuant to the voucher. Like a Medicaid provider, which enters into a contract with the state Medicaid agency, the special needs trustee enters into a contract with the housing authority

requiring that the property be maintained to its standards and that it accept payment under the program.

Section 3. – Types of special needs trusts and their regulation

SNTs operate differently, have different regulatory regimes and are taxed differently depending primarily on the source of assets funding the trust. Source of funds can also determine disposition of assets after the death of the primary beneficiary.

a. First-party or self-settled trusts. Trusts funded with assets of the beneficiary, sometimes called self-settled or first party trusts, stand on special footing. In 1993, Congress enacted legislation to frustrate the use of ***inter vivos*** trusts in Medicaid planning, but excluded trusts for disabled individuals under age 65 provided that, upon the beneficiary's death, any state Medicaid program that provided benefits for the person be reimbursed up to the extent of trust assets. The exception also requires that the beneficiary be under age 65 and "disabled within the meaning of the Social Security Act, 42 U.S.C. § 1382c(a)(3)," and that the trust be established by a parent, grandparent or legal guardian of the beneficiary or by a court, but not by the individual him or herself.

Congress provided a similar exclusion from the broad Medicaid anti-trust rules for trusts created by non-profits to provide trust services for disabled individuals' pooling funds for investment and management. These "d-4-C" or pooled trusts must maintain a separate account "solely for the benefit of" each beneficiary, who must be disabled. The account may be created by a parent, grandparent or legal guardian of the beneficiary, by a court, ***or*** by the individual him or herself. There is a payback requirement, but payback is not required for "amounts remaining in the beneficiary's account upon [his or her death] ... retained by the trust ... ."

The federal statute does not prescribe any particular standard for distributions by the trustees for either individual or pooled SNTs. Practitioners have generally assumed that the then-existing rule for third party trusts applied. Under this rule, based on SSI, trust income or assets are available if the

trustee has a legal duty to make expenditures, for example under a so-called HEMS standard, but if not, then income and assets are not counted as available. This is the rule SSI subsequently adopted for trusts excluded under the SSI trust statute.

b. Third-party trusts. Virtually any trust for the benefit of a disabled person funded by someone else can function as an SNT so long as it has the same discretionary, non-support standard for distributions by the trustee. That enables it to achieve the fundamental purpose of permitting the beneficiary to qualify for SSI and/or Medicaid without regard to trust assets or income, ***per se***.

A third-party SNT can be created either ***inter vivos*** or by will. With one exception of limited application, there is little difference so far as public benefits for the beneficiary are concerned between an ***inter vivos*** and a testamentary SNT. There might, however, be a difference in their use: an ***inter vivos*** SNT can be used to enable the ***grantor*** to qualify for Medicaid long term care benefits. Thus, a nursing home resident with a disabled child or grandchild can meet the resource limits to qualify for Medicaid for long term care benefits by conveying all of his or her "excess resources" to a trust for the disabled child or grandchild.

Third party trusts in general are not bound by the payback requirement that applies to first party trusts. The grantor can provide for disposition of assets remaining at the death of the primary disabled beneficiary, either by his or her own specific bequest to other heirs or legatees, or by reserving a general or limited power to appoint, or by giving the disabled beneficiary or others a limited or general power to appoint.

The trust may be revocable by the grantor during his or her lifetime. If it provides rights and benefits to a disabled beneficiary, it could affect the latter's eligibility.

c. Their regulation. The role of SNTs within the Medicaid system requires that the applicable law be drawn from both federal and state law. Before self-settled trusts were specifically authorized by Congress, courts necessarily looked to state trust law to determine whether a trust

beneficiary's rights under a given trust document rose to the level of rendering income or assets of the trust "available" for Medicaid purposes, the latter a matter of federal law. The Congressional authorization for self-settled trusts in 1993 failed to establish any beyond the most bare-bones requirements, noted above. Because self-settled SNTs were first created by Congress within the Medicaid program, the Secretary of Health and Human Services assigned regulatory responsibility to CMS, the federal agency that administers Medicaid, and thus whose inclination – reflecting the overall structure of the program it runs – was to favor state standards subject to broad, general federal oversight. But unlike the rest of the Medicaid program, which has extensive and detailed federal standards and requirements, there are no significant standards for self-settled SNTs beyond the payback requirement. The result is that the states view themselves as free to impose whatever limitations strike the fancy of state Medicaid administrators, and given their hostility to the expansion of Medicaid, that freedom has been used to hamper, if not cripple, the use of first-party SNTs. Self-settled SNTs are unwanted stepchildren in often unfriendly households.

State regulation of self-settled trusts has been done largely through adjudication and administrative regulation, some quite informal, and partly through legislation. Some of the limitations are quite significant, ***e.g.,*** flat prohibitions on paying family members for providing any good or service to the beneficiary, or making distributions for food and shelter; some are intended to facilitate review and supervision, ***e.g.,*** annual reporting requirements. Even where their use is severely limited, the benefits would appear to outweigh the limitations, but that decision can only be made on a case-by-case basis looking at the state regulation and the particular beneficiary's needs and other resources.

Section 4. Income and gift tax treatment of special needs trusts

SNTs get no special treatment under federal income tax law except for one small deduction added by, of all things, the Patriot Act of 2001. As with almost everything else about SNTs, the source

of trust funds is the major determinant of treatment under the tax code. The common source of different treatment under both public benefits and tax law should not, however, mislead trustees into thinking that the two different regimes treat income the same way. They do not. Many transactions that have no income tax liability create income for SSI purposes, and many taxable transactions do not create SSI income.

a. ***Income tax treatment***

i. ***Tax considerations generally***

Trusts are in general separate income tax-paying entities unless exempted, as with charities, or the income is attributed to someone else, as with grantor trusts. They must file a return if annual income exceeds $600. Trusts can deduct from taxable income distributions to beneficiaries ("distributable net income" or DNI) and so do not pay tax on income that is actually distributed to (or used for the benefit of) a beneficiary. That income is taxed to the beneficiary. While trusts and individuals have the same sequence of slightly progressive tax rates, the sequence for trusts is highly compressed so that a trust pays substantially more tax than an individual with the same income. For 2011, an individual does not reach the highest federal income tax rate until total income is $384,860, while a trust hits that rate when its taxable income exceeds just $11,200. Since the beneficiary of an SNT typically has income only from SSI or SSDI, total income tax liability is usually less if trust income is attributed to the beneficiary, whether or not distributed.

ii. ***First-party trusts***.

Trusts funded with the assets of the beneficiary are subject to the grantor trust rules of the IRC and, as such, will always be – or can be caused to become – "grantor trusts." Where there is a corporate or professional trustee or other non-adverse trustee, the "sole benefit" requirement brings the trust within the rule that the settlor is treated as the owner if he or she has a reversionary interest that exceeds 5 % of the value of the trust. Likewise, the account in a pooled SNT, the so-called d-4-C trust, is

itself also a grantor trust for the same reason, and its income should be reported as the income of the beneficiary himself or herself. Where the trustee is a relative with an interest in the remainder, and is thus adverse, the 5% rule does not automatically apply. The beneficiary can get the same result by retaining the administrative powers used to create defective grantor trusts so long as they do not give the beneficiary control of assets or income that might trigger availability for public benefits purposes, ***e.g.***, "a power to reacquire the trust corpus by substituting other property of an equivalent value."

For tax reporting purposes the trustee has two distinct options. He or she can use the grantor/beneficiary's own Social Security number as the trust tax identification number so that all trust income is reported to the IRS as income of the beneficiary. The beneficiary files his or her tax return reporting all of the income without regard to personal or trust origin. Alternatively, the trust can obtain a taxpayer identification number and file a one-page Form 1041 indicating that the trust is a grantor trust and that all income is reported on the return of the individual. The individual's return shows income in each category, as appropriate, coming from the trust.

The income tax liability is of course the same. The slight advantage to the latter is that it gives the beneficiary a neater handle to explain why the trust income is not income for SSI/Medicaid purposes if, as happens from time to time, the SSI or Medicaid caseworker sees the beneficiary's tax return and wants to treat the income as affecting public benefits.

iii. ***Individual Retirement Accounts***.

A distinct but important question is whether a first-party trust can be the owner of the beneficiary's IRA account. There is a single IRS letter ruling involving a roll-over IRA that went to the child of a decedent, and the question was whether that IRA could be held by the adult child's SNT. The ruling concluded that it could be based almost entirely on the fact that the trust was a grantor trust. While the result is attractive, the reasoning appears to be too broad to give the ruling legs to apply in a variety of other situations. Absent ownership by the SNT, the IRA is an available asset in many

jurisdictions. The only way to avoid the loss of SSI and Medicaid benefits is to cash out the IRA or 401(k), pay the income tax and convey the balance to the SNT trustee. While the fact of the beneficiary's disability excludes the withdrawal from the penalty for early withdrawals, they are still subject to income tax liability.

iv. ***Third-party trusts***.

Third party trusts, on the other hand, are generally separate taxpayers, and the question from a planning and drafting perspective is to whom trust income should be taxed. There are three choices: the beneficiary, the trust itself or, if still living, the grantor. The planner/drafter has options, albeit limited, for shifting the income tax burden from the trust to the beneficiary or the grantor. While these are not different from those for third-party trusts generally, with one small exception, the public benefit implications constrain the choices available.

(1) **To the trust**. To the extent not distributed to (or used for the benefit of) the beneficiary or attributed to the grantor under the grantor trust rules, the income is taxed to the trust itself. The only relief for SNTs is the allowance of an additional personal exemption for "Qualified Disability Trusts" (QDisT) a provision added by the Patriot Act. The maximum savings in 2011, for a trust whose income is being taxed at the top marginal rate of 35%, is $1,312.50 (the 35% rate times the personal exemption amount, $3,750) in federal income tax.

The QDisT provision incorporates by reference the requirements of c-2-B trusts adding additional requirements while assuming provisions that are inconsistent with c-2-Bs. QDisT treatment is available for irrevocable trusts established for the benefit of disabled individuals under age 65 who are getting SSI or SSDI benefits.

(2) **To the beneficiary**. Given the higher trust income tax rates, total tax liability will be less if the income is taxed to the beneficiary or, if not the beneficiary, then to the grantor. If to the beneficiary, the problem is how to do so without loss of public benefits for the beneficiary. To be

sure, all expenditures for the benefit of the disabled beneficiary are distributions of income to the extent of trust income. For a trust that will usually spend most of its net income on the beneficiary, the planner need spend little if any time on special measures to carry additional income out to the beneficiary or the grantor.

For trusts that cannot usefully spend all income for the benefit of the beneficiary in a given year, one solution, if authorized in the trust, is to make distributions to a d-4-A payback trust or an account in a d-4-C pooled trust. Such a distribution is taxable to the beneficiary at the beneficiary's marginal rate, but it is not "available" for SSI or Medicaid purposes in the d-4-A trust or d-4-C account.

The savings can be substantial. A trust with net taxable income of $30,000 could transfer $10,000 to a payback trust for a beneficiary getting SSI benefits only, and no other income. The $10,000 that would have been taxed at 35%, costing $3,500, for the trust, will in the hands of the beneficiary be taxed at about 15% or less, saving $2,000 or more. The savings may be somewhat less in the case of an SSDI recipient, since some portion – 50% or 85% – of his benefit is subject to tax if his total taxable income reaches certain thresholds. Thus, a dollar distributed from the third-party trust to a payback trust may avoid tax at 35% to be taxed at 15% itself but also subject 50% to 85% of a dollar of SSDI income to tax, likely at the 15% rate.

The drawback, of course, is that the payback trust has what amounts to a 100% tax on principal and income at the time of the beneficiary's death in the form of the Medicaid payback. To the extent the beneficiary is young, or at least has a significant life expectancy, he or she benefits from distributions to a d-4-A trust that reduce present tax liability where the savings may well be used, in turn, for his or her benefit. A trustee should not be criticized or, worse, held liable because he sought to extend the useful life of a third-party trust by minimizing tax liability through distributions to a d-4-A trust unless they were made at a time when they would plainly do the beneficiary little good.

(3) **To the grantor**. The remaining alternative is to give the grantor, while living, rights or powers that make the trust a defective grantor trust, at least as to a portion of the trust. Among the provisions that are available are the retained powers to dispose of the income or "beneficial enjoyment" of the principal, administrative powers to deal for less than adequate consideration, to borrow without adequate interest or security, to control the investment of trust assets (if grantor and trust own assets that affect voting control), or to reacquire trust corpus by substituting property of equivalent value, to revoke, to direct that income be distributed to the grantor or spouse, or held for accumulation for such later distribution, or to pay life insurance premiums for the grantor or spouse.

b. ***Gift tax treatment***

Funding a first-party trust or a revocable third-party trust is not a gift for federal gift tax purposes, nor are distributions from an irrevocable trust or a first-party trust. Funding an irrevocable third-party SNT may be a completed gift, depending on whether the grantor is the trustee or has retained a power to appoint. Distributions from a revocable SNT are also gifts.

Funding the irrevocable trust can utilize the lifetime gift tax credit, of course, which with the 2010 Tax Relief Act is $5,000,000, at least through 2012, reducing if not eliminating the incentive to attempt to use Crummey powers in most cases. This is fortunate, because Crummey powers are largely inconsistent with SSI and Medicaid eligibility for the power holder. The right that arises when the gift is made is income in the month that the beneficiary obtains the right. If not exercised before the first day of the next month, it is an available resource for the later month. The lapse of the power is not treated as a gift to the trust, however, so that use of a power when the person is not getting SSI or Medicaid would not infect the trust, as it were, and require a payback provision ever after for that portion of the trust.

On the other hand, Crummey powers in non-contingent remainder beneficiaries, such as the grantor's other children or their issue, so called Cristofani powers, should not affect the eligibility of

the disabled beneficiary. On the other hand, few people get rich over-estimating the tax sophistication of state Medicaid officials, who may see the right to withdraw as violating the "sole benefit" requirement of c-2-B SNTs.

If the SNT is still revocable by the grantor, distributions from the trust for the benefit of the beneficiary are gifts by the grantor, and can take advantage of all of the usual gift tax exclusions, including those for payments made directly to a medical institution as well as the annual gift tax exclusion and the lifetime credit.

c. ***Estate tax treatment***

The first party trust is includible in the beneficiary's estate. This will of course be less significant with the current $5,000,000 credit amount under 2010 Tax Relief Act. Given the constraints of d-4-A, there are relatively few opportunities for effective estate tax planning. The trustee cannot fund an irrevocable life insurance trust, for example, even assuming the disabled beneficiary is insurable, nor transfer home property to a qualified resident trust. The trustee might be permitted to invest in assets that are part of a family limited partnership or limited liability corporation that can enjoy a discount for lack of control.

For estate tax purposes a third-party SNT is no different from any other trust. If revocable, it is included in the grantor's estate. If not, whether it is includible depends on what kind of powers of disposition the grantor has retained. The power of appointment that is used for estate tax purposes should not have any significant consequences for SNT treatment.

Section 5. Practical drafting and operational issues.

SNT drafting is driven by two considerations not present with most trust drafting – satisfying the public benefits requirements to avoid being counted as available and having enforceable protections to assure that the trust will continue to serve the interests of the disabled beneficiary for as long as the trust is in existence. These considerations affect drafting throughout the document. Beyond drafting, there

are significant operational concerns – funding and use of the trust – that both drafters and trustees should consider. Just as the rules relating to SNTs have been developed by public benefits officials with little knowledge or appreciation of trusts or trust law, so much of the drafting of SNTs has been done by lawyers who are public benefits lawyers first, and trust lawyers only out of necessity. Anyone picking up an existing document as a guide would do well to review the thoughtful critique of a model SNT by an experienced trust and estates lawyer.

Recitals. The recitals should identify the parties – settlor, trustee and beneficiary – their relationships, the remainderman and their relationship to the grantor, and the intent of the grantor that the trust be an SNT that does not interfere with public benefits and, if applicable, that it should have Qualified Disability Trust status. If the trust is a payback or c-2-B trust, it should also recite the age (with date of birth) and disability of the beneficiary and the relevant federal law and state statute or regulation governing funding and availability. A c-2-B trust should also state its purpose of permitting the grantor to qualify for Medicaid long term care benefits.

Distribution standard and directions. The distribution standard is the key to assuring that the trust does not, by its mere existence, render income or assets available for public benefits purposes. Aside from that, there are important considerations as to the scope of or limits on trustee discretion and benefits to spelling out the intended uses of the trust.

First, for all SNTs, the distribution provision should reiterate that the settlor's purpose is to coordinate trust assets and income with means-tested public benefits. It should then provide illustrations to indicate the breadth of permissible distributions.

Second, a payback trust should specify that it is for the sole benefit of the disabled beneficiary whose assets funded the trust. This would have the effect of relieving the trustee of any obligation under the duty of impartiality to provide for remaindermen at the expense of the disabled beneficiary.

Similarly, a c-2-B trust whose purpose is to enable the donor funding the trust to qualify for Medicaid long term care must specify "sole benefit" for the trust beneficiary, and must provide for distributions on an "actuarially sound basis" or for Medicaid payback for the trust beneficiary. Other third-party trusts do not have to be for the sole benefit of a disabled beneficiary. Such trusts could be pot trusts or otherwise be authorized to make distributions to others.

Third, the most common distribution standard for all SNTs gives the trustee broad, unreviewable discretion to determine when, in what amount, for what purposes, and to whom to make payments. Except for general fiduciary duties that, ***inter alia***, limit self-dealing, this leaves the trustee unfettered power to spend or not spend funds for the beneficiary. While traditional public benefit analysis of "availability" would not require that trustee discretion be so totally devoid of guidance, the standard view is that the trustee's discretionary authority should be "sole, absolute, and unfettered." If the trustee is a relative, especially a parent, it should exclude distributions to satisfy any obligation of support that the trustee might have for the beneficiary.

Within that standard, there is a division of opinion whether trustees should be prohibited from making distributions for goods or services available from public benefits programs or, on the contrary, specifically authorized to make such distributions when the trustee determines it to be in the beneficiary's best interests to pay for goods or services, otherwise available, because of their quality, quantity or frequency. If the former is not required by a state Medicaid agency, and there is no reason to doubt the trustee's ability to exercise good judgment as to the latter, then the more generous standard would seem to be most in the beneficiary's long term best interest.

Fourth, for third-party trusts that might not be able to distribute all income in a given year, the trustee should be authorized to distribute income to a d-4-A grantor trust or a d-4-C account to carry out income that would otherwise be subject to income tax at trust tax rates.

Fifth, if the trust is to own home property, likely for the use not only for the beneficiary but also family members upon whom he or she relies, the trust should specifically authorize the trustee to take into account the benefits to the beneficiary of living in that setting, with close family members, in establishing rent and managing the property. As with payments to family members, discussed below, the trustee should support this authority with court orders whenever possible.

Sixth, if the trust is expected to pay family members for any services they might provide, especially personal care for the beneficiary, the trust should specifically authorize the trustee to do so. While SSI policy clearly permits such payments, some state Medicaid programs do not.

Finally, self-settled d-4-A trusts should authorize the trustee to establish a burial trust or fund for the beneficiary since they are prohibited from making a distribution for burial after the death of the beneficiary.

Post-mortem distributions. As just noted, d-4-A trusts cannot pay for the burial costs of the beneficiary, but third-party trusts can, though the authority must be spelled out. The d-4-A trust should be authorized to make those distributions that are permitted prior to satisfying payback, ***e.g.,*** taxes due by reason of the existence of the trust assets and the beneficiary's death and the costs of administration.

It is usually advantageous for the trust to be included in the beneficiary's federal estate tax estate, to get stepped-up basis, easily achieved by giving the beneficiary a general power to appoint. This benefit has to be weighed against the risks of giving that power to someone who may have poor judgment.

In general, d-4-A trusts should, if the beneficiary lacks capacity, make distribution of any assets remaining after payback to the heirs at law of the beneficiary, whose assets funded the trust. But some state laws permit intestate succession to bypass parents who fail to support a child, and those who would take through them. A settlor establishing an SNT should consider incorporating such provisions.

Whether court-created or only court-funded, the petition should allege the facts supporting

disinheriting the non-supporting parent and evidence proffered at a hearing, with specific findings made. If the beneficiary is competent, the trust can reflect his or her wishes, implicitly conferred by funding the trust, but a record should be made of the beneficiary's decision, such as by an independent contemporaneous will.

For third party trusts, a troubling issue in many cases is how to deal with a disabled adult child's potential for leaving issue with whom they have no relationship but who would be entitled to take on the disabled child's death. At the very least, the settlors should review what they think is likely and whether they would want any assets to be distributed outright, or held in trust, for unintended issue, or instead pass to other issue of the parents.

Fiduciary provisions and authority.

For d-4-A trusts, the trustee should be authorized to require adequate proof of Medicaid's payback claim and to pursue administrative review if not satisfied.

The trustee should be authorized to act on behalf of the beneficiary and to expend funds for legal representation, especially for applying for or protecting public benefits. In drafting such a provision, the settlor should decide, and make clear, yea or nay, whether he or she intends to make this an affirmative duty of the trustee.

Third-party trusts should contain the common administrative provision permitting termination if the trust becomes too small to warrant continued existence, but with distribution to a pooled trust account. First party trusts are not permitted under SSI to terminate by payment to a d-4-C trust without first paying off any Medicaid claim.

As noted above, if the trust is expected to own a home, the trustee should be authorized to make best interests determinations respecting how much, if any, rent to charge close relatives.

If the trust might provide a vehicle for use by, or for the benefit of the beneficiary, the trustee should be authorized to purchase it in the name of a third party, securing its interest through a lien. The

same elements that protect the trust's financial interest in the vehicle are the ones that would support a claim of vicarious liability based on ***de facto*** ownership. Paying for use of the vehicle, at IRS vehicle expense rates, is a reasonable alternative if there is someone in the household able to purchase the vehicle.

The trustee should be authorized to retain a care manager and other independent professionals whose knowledge or experience may be relevant for someone with the beneficiary's disabilities.

Without doubt the most sensitive question is how to assure on-going trustee fidelity for a beneficiary who lacks the ability to protect his or her own interests. Family member trustees may not be sensitive to their fiduciary duties. Trust departments change over time, get acquired, and change policy, and certainly personnel change. The idea of a "trust protector," ombudsman or trust committee has developed among SNT practitioners as the mechanism for providing a useful check on trustees for whom judicial review is limited to abuse of discretion. The protector/ombudsman might be given the power to remove a trustee, either for cause or not.

The flip side of the problem is what kind of obligation that puts on the trust protector. To the extent it makes him or her a fiduciary, it would require more time and effort and thus more cost to the trust. The alternative is an "on call" ombudsman who has no affirmative duty to act except upon actual notice or request from the beneficiary or someone interested or knowledgeable about his or her welfare.

Funding. Funding is especially complicated when the trust is for the benefit of a child of the grantor who has one or more other, non-disabled children, but every SNT presents funding problems.

For a self-settled d-4-A trust to serve its purpose of permitting the beneficiary to qualify for means-tested public benefits, ***all*** non-exempt assets of the beneficiary – including qualified plans – must be disposed of, either by transfer to the trustee or some other appropriate disposition. SSI policy requires that the funding be properly authorized. If the beneficiary lacks the legal capacity to transfer

his or her assets to the trust, either because of age or mental incapacity, a parent or other interested person will need to seek a guardianship court order authorizing the transfer of assets to the trustee.

Whether to place an existing principal residence into an SNT, or how to title a residence being purchased in part by an SNT, depends on, among other considerations, whether SSI is involved, the beneficiary's life expectancy and potential need for long term (nursing home) care, and whether and to what extent he or she has children or others they would like to benefit. If an SNT pays housing costs of a home owned by the beneficiary, SSI considers that ISM and reduces the SSI payment accordingly. If the house is an asset of the trust, then payment of most maintenance costs is simply protecting an asset of the trust. If the home is owned by the trust, it is subject to the payback requirement, even if parents, siblings or children live in it and may have lived in it for years at the time of the beneficiary's death. If it is owned by the beneficiary, it is subject to estate recovery only for services provided after age 55 or, if the beneficiary requires long term care, if the state filed a lien against the house or if subject to probate and no recovery exemption applies (co-owner sibling, disabled or under-21 child).

The third-party trust is typically established by a parent who may want to treat all children equally, but they should consider whether equal is "fair." Bringing the healthy sibling into the decision-making may or may not help. Some may well recognize the need for unequal distributions. But it is not uncommon for the healthy child to feel that the disabled child, having already gotten the bulk of the parents' attention during their youth, should not continue to get more than an aliquot share of what the parents have to give.

That said, assessing needs far into the future is something of a fool's errand, no matter how necessary it might be. The variables are tremendous. The uncertainties of return on investment, inflation, and life expectancy over an extended period of time are compounded by other uncertainties, including what public benefits will exist, and whether they will be available and on what terms, for

the beneficiary, during his or her lifetime, and what role close family members will play in the life and care of the disabled beneficiary. Notwithstanding the vast uncertainties, parents should find it useful, if sobering to the point of being distressing, to confront the financial needs of their disabled child. Life care planners, financial advisors, and on-line services such as "Met Desk Calculator," operated by MetLife's Division of Estate Planning for Children with Special Needs (www.metlifeiseasier.com/metdesk/), are all useful sources of information.

Making distributions. Likely the most common problem is how to handle distributions for day-do-day living costs for a beneficiary of limited capacity.

For beneficiaries able to handle a credit card, the simple solution for paying for small daily items is a credit card or a pre-paid debit card in the name of the beneficiary, the trust, or, if nothing else is available, the trustee him or herself for which the beneficiary is an authorized signer, providing that records are kept as meticulously as circumstances and the beneficiary's capacity permit. Neither SSI nor Medicaid treat payments for the liability created by a credit card as income, other than ISM. There is no simple solution for the beneficiary who is unable to use a credit card because of cognitive limitations or lack of self control. Distributions and reimbursements to a care manager or house manager may work.

Payments to family members should be handled so that, if challenged after-the-fact by the Medicaid agency, the trustee can establish their reasonableness and that they are in the best interests of the beneficiary. This is one of those areas where CMS' position that states are free to limit the use of SNTs collide with federal SSI policy, which permits, albeit with a somewhat skeptical eye, payments to care-providing family members, as discussed above. While the ***Hobbs*** case shows that obtaining a court order authorizing the payment is not a fool-proof defense against a Medicaid challenge, plainly it is still the epitome for establishing reasonableness. The Medicaid agency should be notified of the petition for judicial approval. The evidence proffered should include the cost of

alternative sources of care, independent expert testimony as to the advantages of parental or family member care, and the care-giver's training, experience, or other qualifications. The final order should, if the court is agreeable, find all relevant facts favoring payment and the reasonableness of the amount, and should require, not just authorize, payments to the family member for care.

Conclusion

SNTs are the odd duck in estate planning in the same way that they are to the public benefits system. They require family members and trustees used to handling wealth to learn and be sensitive to a set of rules largely designed for people with little or no wealth at all. At the same time, public benefit agencies must deal with significant assets and income and a legal tool for managing them when their usual operating procedures address only the needs of people with nothing. The well-drafted and well-managed SNT that walks this tightrope successfully enables parents and others to enrich the lives of their disabled children and others immeasurably.

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