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AN INTRODUCTION TO SPECIAL NEEDS TRUSTS

I. INTRODUCTION

Special Needs Trusts, also called Supplemental Needs Trusts, are trusts designed to provide assets for the care and comfort of disabled and elderly beneficiaries without jeopardizing their access to programs, funds and/or medical benefits that may be available to them. The cost of care for many disabled persons can be prohibitive and is simply out of reach for most people to afford privately. Because many government-funded programs in the United States today provide substantial benefits, and in many cases are the only available programs for disabled persons, access to these services is critical. However, the requirements for qualifying for these benefits often thwart the efforts of families to provide support to their disabled loved ones.

To qualify for government benefits for disabled individuals, a person must meet the definition of “disabled.” A disabled person, according to the Social Security Administration, is a person who is over the age of 65, blind or unable to do any substantial gainful activity due to severe physical or mental impairments that will result in death or which have lasted for more than one year or will continue for not less than one year. 42 U.S.C. § 423(d) (1) (A). “Substantial gainful activity” is the ability to do work that produces earnings. “Physical or mental impairments” are disabilities that appear on the Social Security Administration Listing of Impairments. If drug addiction or alcoholism are contributing factors to the disability, and if the

individual does not accept treatment, eligibility can be suspended.¹

Once a disability is established, the type of benefit available will depend on additional criteria. Some programs, such as Social Security Disability Income (“SSDI”), base the benefit on the earnings of the worker prior to her disability. With this benefit comes Medicare, which is an entitlement medical insurance program available to all workers who are disabled or to all people who have attained age 65. Receipt of SSDI and Medicare depend exclusively on disability or age and prior work history. There is no limit to unearned income or assets that can be owned by an SSDI or Medicare recipient. In contrast, programs such as Supplemental Security Income (“SSI”) and Medicaid are “means-based” programs, which measure the current income and resources of the disabled person to establish eligibility. In order to access these benefits, the recipient must not only be aged, sick and/or unable to work, but very, very poor. If significant assets become available to an SSI or Medicaid recipient, the benefits will be curtailed until those assets are used up. When the excess assets are gone, the disabled person can reapply for the benefits.

Government benefits for the disabled include cash payments and health care. SSI and SSDI provide cash for disabled individuals. For most recipients, this is the only monthly cash that they receive. The primary government health care programs are Medicare and Medicaid.

Medicare provides coverage for acute care, such as hospitalization and some limited rehabilitation. Under the Medicare law passed in 2003, prescriptions can be covered beginning in 2006.² Medicare recipients may also have access to private health insurance, which often pays for prescriptions and doctor visits. Medicare is administered directly by the federal government.

¹ POMS Section SI 00501.001. The “POMS” are the regulations described under the Program Operation Manual System, which are written to instruct Social Security caseworkers in the various offices throughout the United States. One can access the POMS pertaining to Supplemental Security Income at <https://s044a90.ssa.gov/apps10/poms.nsf/chapterlist!openview&restricttocategory=05>. The POMS that are pertinent to the subject of this paper are found in the SI-Supplemental Security Income section. While the POMS do not carry the weight of regulations (see *Ramey v. Reinertson*, 268 F.3d 955 (10th Circuit 2001)), they are very helpful and the most detailed policy guidelines that exist in the area of special needs trusts.

² Medicare Prescription Drug, Improvement, and Modernization Act of 2003, www.medicare.gov. Medicare and Medicaid are administered by the Centers for Medicare and Medicaid Services (“CMS”) under the United States Department of Health and Human Services.

Medicare does not cover the cost of long term custodial care. Very few health insurance policies will cover long term custodial care. Long term care insurance will pay for custodial care, but it is not available for someone who is already disabled.

Medicaid is the only government program in the United States that provides for long term skilled nursing care for disabled persons other than Veterans Affairs. Medicaid pays for prescriptions, therapy, and doctor visits as well as custodial care. Medicaid, while a federal program, is administered by the states. Therefore, a Medicaid recipient who moves from one state to another state will have to reapply for Medicaid services in the new state of domicile. Regulations differ from one state to the next. In New Mexico, Medicaid provides funding for various programs, which include SALUD! which provides Medicaid HMO services through Molina, Blue Cross and Blue Shield, Presbyterian and Lovelace, institutional care in nursing homes and other facilities, financial assistance for the payment of Medicare premiums, Total Community Care which is home based services for the elderly (available only in Bernalillo, Valencia and Sandoval counties), and Disabled and Elderly (“D&E Waiver”), Developmentally Disabled (“D&D Waiver”) and Medically Fragile programs which provide community based services for disabled individuals of all ages.³ In order to qualify for these benefits, a recipient must be disabled and must be essentially indigent. There is a limitation on the amount of income that a Medicaid recipient can receive each month (\$2,022 in 2010), and the total amount of countable resources that a Medicaid recipient can have in any one month is \$2,000.

The dilemma for families with disabled family members has always been how to adequately provide a decent and meaningful lifestyle for their loved one while at the same time guaranteeing access to these benefits. Historically, families have tried various methods to protect the benefits for a disabled family member when additional assets may have been available that would cause disqualification. They might intentionally disinherit the loved one. They might attempt to create oral trusts or other arrangements with surviving family members. These methods have often had heart breaking and cruel results or are ineffective or blatantly fraudulent.

³ Information about these services can be found at <http://www.state.nm.us/hsd/mad>.

On the other hand, many relatives cannot bring themselves to disinherit a disabled beneficiary. As a result, the disabled beneficiary receives a gift or a share of an estate outright, and thus loses her government benefits until the gift or inheritance is used up. Planning with Special Needs Trusts can solve this dilemma.

An exasperating though common occurrence is a disabled child of a deceased parent receiving automatically a lump sum payment from Social Security that is the accumulated SSDI benefit of the deceased parent. The child is entitled to this benefit, which is a continuation of the parent's Social Security benefit. However, because Social Security may have taken two years to compute the benefit after the death of the parent, it arrives as a lump sum that is far more than \$2,000. The receipt of this payment, though received because the child is disabled, will cause ineligibility until the excess resource is used up. Planning with Special Needs Trusts can solve this dilemma.

Some disabilities are the result of someone else's negligence. In these cases, the disabled person may recover damages. However, the injured person may require lifetime assistance at enormous cost, which may be well beyond the amount of the recovery. Treatment of the effects of the injury necessitates government-provided benefits. Therefore, even though a recovery may provide substantial assets, the recovery itself can put access to these benefits at risk.⁴ Planning with Special Needs Trusts can solve this dilemma.

Finally, one can never predict whether or not a future beneficiary may become disabled. Estate planners can build language into their documents that provides for contingent special needs trusts in the same manner that most documents now provide for contingencies such as minority trusts.

II. HOW THE GOVERNMENT BENEFITS SYSTEMS WORK

A. The Basics

Planning for disabled beneficiaries requires a basic understanding of how government

⁴ For more information about how to protect public benefits for disabled plaintiffs who recover damages throughout the United States, contact the Special Needs Alliance, www.specialneedsalliance.com.

benefits systems work. These programs disburse benefits to millions of people in the United States every month. Yet, most people, particularly professionals, do not have a grasp of the features and the distinctions among them. The names of the programs are very similar, which makes it more confusing. While access to the means-based programs requires special planning, it is important to know how other programs interrelate and in some cases complement the means-based programs. To help in that understanding, I have prepared two simple charts to illustrate and compare three programs provided through Social Security and to compare Medicare and Medicaid.

Comparison of Three Social Security Programs

SSI	SSA	SSDI
Supplemental <u>Security Income</u>	<u>Social Security</u>	<u>Social Security Disability Income</u>
Disability	Retirement	Disability
Cash + Medicaid	Cash	Cash + Medicare (After 2 years)
No work history	Work history	Work history
Income Cap - \$674/month in 2010	Income Cap - \$14,160/yr in 2010, if under age 65	Income Cap - \$980/month in 2010
Earned & unearned income	Earned income	Earned income
Resource cap - \$2000.00	No resource cap	No resource cap
Minimum cash benefit	Insurance	Insurance
Food and shelter	Unrestricted	Unrestricted
State supplements (Not NM)	Uniform in all states	Uniform in all states
US citizens only	All workers	All workers
May also have SSDI	May not have SSI or SSDI	May also have SSI
No dependent coverage	Covers dependents	Covers dependents

Comparison of Medicaid and Medicare

	Medicaid	Medicare
Program:	Health Care	Health Insurance
Administered by:	States	Federal
Eligibility:	Must Qualify	Entitlement
Qualifications:	Financial <u>&</u> Disability	Age <u>or</u> Disability
Covers:	Several in-home care programs; Skilled nursing care; Long Term care; Prescriptions	Hospitalization; 100 days maximum rehabilitation; Prescriptions
Contribution:	Reimbursement required	Premiums and co-pay
Estate Recovery:	Yes	No

B. Means-Based Programs

In 1965, President Johnson signed the bills that created a health insurance program for retired Americans, Medicare, and a health care program for needy families, Medicaid. The bill was an amendment to the Social Security Act. It had originally been proposed by Harry Truman in 1945. In 1972, President Nixon signed the Social Security Amendments of 1972 which created the Supplemental Security Income (“SSI”) system. Although the benefits under Medicaid and SSI are different, the rationales for the two systems are quite similar, and both find their statutory basis in the Social Security Act. SSI provides minimal cash payments each month that are designated to provide for food and shelter. In order to maintain eligibility for SSI, a recipient cannot receive income from any source in excess of \$674.00 per month in 2010. Income, according to the SSI rules, is anything that “comes in” to the recipient in any month. At the end of the month, income that is not used up converts to a “resource.” Thus, a resource can be accumulated income. An SSI recipient may not own resources that are available to be spent on food and shelter in excess of \$2000.00. Income and resources are measured independently. The analysis for Medicaid eligibility is quite similar, although the income threshold is higher. In New Mexico, for most Medicaid programs, the income threshold in 2010 is \$2,022.00 per month.

Some income and some resources are exempt from the eligibility calculations. Non-countable income includes other means-based payments such as food stamps, medical care and services, income tax refunds, loans, and any item that if retained would not be a countable resource. Exempt resources include the personal residence of the recipient; one vehicle, if it is needed to provide transportation to work, to medical services or is specially outfitted for the disability; household contents, such as computers, electronics, physical training equipment, hot tubs and ordinary furnishings for living; life insurance with a face value of less than \$1500.00 and irrevocable burial plans. Thus a disabled adult who owns a \$400,000 house,⁵ a \$60,000 specially-outfitted van, whose life is insured by a \$2 million term life insurance policy, and who

⁵ The Deficit Reduction Act of 2005, signed by President Bush on February 8, 2006, requires that Medicaid eligibility shall be denied to applicants who have more than \$500,000 in equity in their home. New Mexico has by regulation increased this figure to \$750,000.

has limited income, could qualify for SSI.

Income and resources of family members can be deemed to a disabled family member under the SSI rules. This deeming concept is an odd one, but the rationale is that since SSI benefits are to provide food and shelter, if an SSI recipient is receiving some of those items from another source, then the ability of that source to provide those items is “deemed” to the SSI recipient, as if the SSI recipient were able to provide these services by herself. For example, in order to maintain SSI eligibility for a disabled child, a family which is supporting three children, one of whom is disabled, will be limited in the total amount of income that the family may earn each month, if it wants to protect the disabled child’s benefits. A portion of the family’s income will be deemed to belong to the SSI recipient. If the family earns too much income, the disabled minor child will not be eligible for SSI. There is a similar analysis for deeming resources.

But why is this significant? The government-provided cash benefit under SSI is paltry, a maximum of \$674.00 per month in 2010. The amount of the SSI benefit is so small that maintaining SSI eligibility hardly seems to be a worthy goal. The prize that makes the quest worth pursuing is Medicaid. In many states, including New Mexico, eligibility for SSI categorically results in Medicaid eligibility. For many disabled individuals, such as disabled children, disabled adults who have no work history, and disabled adults whose work history does not provide an SSDI benefit at all, or one that is below \$674.00 per month, SSI provides the gateway to the substantial medical benefits of Medicaid. As the charts demonstrate, no other government benefit besides Medicaid provides comprehensive, long term medical care. Therefore, observing the qualification criteria for SSI will enable a beneficiary to receive medical care that she may not be able to obtain from any other source. If an individual is unable to qualify economically for SSI, she may be able to apply directly for Medicaid. The eligibility requirements for Medicaid are still means-based, requiring that the individual have minimal countable income and resources, but there are not the same deeming rules as there are with SSI.

III. REQUIREMENTS OF SPECIAL NEEDS TRUSTS

A properly drafted Special Needs Trust preserves and shelters assets for the benefit of a disabled person so that she can obtain means-based benefits and have additional comforts, enjoyment, education, entertainment and medical care not otherwise provided by the government programs. In order for a Special Needs Trust to qualify as a non-countable resource, it must be written and its terms express. All distributions of income and/or principal must be in the discretion of the trustee. The beneficiary cannot be entitled to receive income or principal. The Trustee must be prohibited from making any distribution that would jeopardize the recipient's benefits. The Special Needs Trust can delineate those items or categories for which distributions are proper. The language should never require distributions for health, support, food, clothing or shelter. The disabled individual must be the sole beneficiary of the trust during her lifetime. A Special Needs Trust must be irrevocable. However, the terms of the trust should always allow the trustee to reform the trust to protect eligibility for benefits.

A. Third Party-Settled Trusts

The least problematic Special Needs Trust is the third party-settled trust.⁶ This can be either an inter vivos irrevocable trust or a testamentary trust. If the Special Needs Trust is a testamentary trust, it is settled law that it will not be counted as a resource for a disabled beneficiary.⁷ For a person other than the disabled individual to fund an irrevocable Special Needs Trust for that disabled beneficiary during the lifetime of the grantor, even though it is not a countable resource, it is advisable to have the trust agreement reviewed by the case administrator in the Social Security office before funding, so that one is not accused of failing to disclose information. A third party-settled Special Needs Trust can provide for a testamentary special power of appointment for the beneficiary, or can provide that the trust be distributed to the chosen remainder beneficiaries of the grantor at the death of the beneficiary. The corpus of a

⁶ The POMS exclude third party trusts from special scrutiny. POMS SI 01120.200.

⁷ Transmittal 64, issued by Sally Richardson of the Health Care Financing Administration (now CMS) in November, 1994, states that for the purposes of Medicaid, the definition of "trust" does not include a trust established by Will. Section 3259.1.A.1. Transmittal 64.

third party-settled Special Needs Trust can be preserved for future beneficiaries. There is no need for independent review of a third party-settled Special Needs Trust by Medicaid, although Medicaid may request such a review.

B. Self-Settled Trusts

In 1993, Congress provided in 42 U.S.C. § 1396p that a person could not attain Medicaid eligibility by transferring her own assets to an inter vivos trust, even if the trust was irrevocable and the Medicaid applicant had no further control over the assets, **unless** the transfer took place more than 5 years before the Medicaid application.⁸ A transfer to the trustee within the 5 year period results in the assets being attributed to the applicant for the period of time that it takes to use up those assets to pay for the care of the applicant. This “penalty period” can put the applicant in the worst possible situation, i.e., not having the assets to pay for care, but being penalized as if the applicant has the assets, and therefore being unable to obtain Medicaid.⁹ Transferring one’s own assets to a trust as a planning method 5 years in advance of need is only feasible when the disability can be planned for, such as with a Parkinson’s patient or an Alzheimer’s patient.

For victims of accidents or disabling conditions from birth or with an unpredictable onset, this is not an option. Under SSI rules, a plaintiff in a personal injury suit is deemed to have constructive ownership of any recovery. Even if the court establishes a special needs trust, the assets are attributed to the plaintiff. However, under 42 U.S.C. § 1396p (d)(4), two types of safe harbor trusts are described that can relieve this dilemma for SSI and Medicaid eligibility. Transfers of the disabled person’s assets to these statutory self-settled trusts are exempt from the transfer penalty.

1. “(d)(4)(A) Trusts”

The first type of trust is provided for in 42 U.S.C. § 1396p(d)(4)(A) and is commonly

⁸ The Deficit Reduction Act of 2005 extended this five year look back period for trusts to all transfers of any sort.

⁹ The Deficit Reduction Act of 2005 mandates that the date of any transfer within the past five years will be deemed to be the date of the application for Medicaid, which means that the penalty period for a transfer begins on the date of application.

called a “d4A” trust. Because the d4A trust is funded with the beneficiary’s own assets, the statute requires that at the death of the beneficiary, the remaining assets in the trust must be used initially to reimburse any state government that provided Medicaid to the beneficiary during her lifetime. Therefore, this trust is often called a “payback trust.”¹⁰ In addition to the payback requirement, the d4A trust must be irrevocable; it can be created only by a parent, grandparent, court or guardian; and the disabled beneficiary must be younger than 65. Funds of the beneficiary transferred to the trust after age 65 will not be exempt transfers. Anyone other than the disabled person can be the trustee of the trust. The trust can provide that after the beneficiary’s death, once Medicaid is reimbursed, the remaining balance of the trust fund can be distributed to the intended beneficiaries of the disabled person.

The limitations on permissible grantors can be cumbersome. The beneficiary cannot be the grantor, even though the assets being transferred to the trust are attributed to the beneficiary. If a disabled beneficiary is incompetent, it is a simple matter to have a conservator appointed to create the trust. However, a disabled adult who has no living parent or grandparent and who is competent has more difficulty complying with the statute.¹¹ If the funds are not the result of a settlement by which a court could create the trust, and there are no parents or grandparents, the disabled person must submit to a limited conservatorship being used to fund the trust in order to comply with the statute.

The trust document will be reviewed by the Social Security Administration and, because of the payback provision, by Medicaid. The standard of review should be the same. However, for the past several years in New Mexico, the General Counsel’s office that represents Medicaid

¹⁰ In the New Mexico Medicaid regulations, (d)(4)(A) trusts are incorrectly described as “reversionary trusts.” MAD-MR: 8.281.500.15 D(1). Medicaid does not hold a reversionary interest in the trust.

¹¹ POMS SI 01120.203.B.1.e specifies that “the person establishing the trust must have legal authority to act with regard to the assets of the individual.” It is considered an invalid trust if the parents of a competent adult child create the trust as settlors, and then pursuant to a power of attorney deposit the assets of the child into the trust. Currently there are two solutions to this dilemma. The first is to petition the court for a limited conservatorship specifically for the purpose of transferring the assets of the disabled adult child into the trust. The second is a device created by the Social Security Administration called the “seed trust” or the “\$10.00 trust.” With this device, the parents deposit \$10.00 of their own funds into the trust, thus “establishing” the trust, and then transfer the child’s funds into the trust using the power of attorney.

has initiated a separate review for each self-settled trust and has been aggressive in its approach. It has determined that self-settled trusts in New Mexico should conform to a certain form. That form was one that was attached as a sample form to materials prepared by Attorney Susan Tomita for a seminar on Medicaid given in 2003. There has never been a regulation passed, hearings held, any public comment solicited, or any agreement reached on whether this trust form should be adopted in any official capacity for New Mexico. However, self-settled trusts prepared by various attorneys are commonly rejected by the General Counsel's office unless they conform to this form.¹² New Mexico Medicaid, through the General Counsel's office, has established further restrictions that narrow the effectiveness of self-settled special needs trusts. For example, while the Social Security POMS provide direction for how a special needs trust can own and administer housing for an SSI beneficiary,¹³ New Mexico Medicaid prohibits a d4A trust from owning real estate for the benefit of an SSI beneficiary. There is no statute or regulation in New Mexico to that effect, just an informal policy. Additionally, Special Needs Trusts can provide compensation for caregivers and pay for the cost of travel for a caregiver to accompany the disabled individual. However, New Mexico Medicaid as a matter of policy prohibits such payments from the trust if the caregiver is a parent of a minor child beneficiary, although there is no such prohibition in the POMS, nor in federal or state regulations. When preparing a self-settled special needs trust for a beneficiary or her family, one must counsel the clients carefully that while Social Security may approve the trust, there is still a Medicaid hurdle in New Mexico. The trust agreement should provide that the trustee can amend the trust in order to protect the benefits of the beneficiary. Although the General Counsel's office will not review a trust unless it has been fully executed and funded, and while scrutinizing self-settled trusts strictly, the office does have a liberal policy towards amending the trusts.

¹² The form is available through the General Counsel's office (505) 827-7701, or you can contact me and I will be happy to provide you with a copy of the form.

¹³ See POMS SI 01120.202.F.5.Example 2 which describes a self-settled special needs trust holding an excluded resource, which is the home of the SSI beneficiary.

2. “(d)(4)(C) Trusts”

The second type of safe harbor for a self-settled trust is found in 42 U.S.C. §1396p(d)(4)(C). In this case, if the disabled person transfers her own funds to a non-profit 501(c)(3) organization as trustee, which manages the funds as part of a pooled trust for disabled persons, the transfer is exempt from penalty. In this case, the federal statute provides that the trust must be irrevocable; it can be created by the beneficiary as well as by a parent, grandparent, court or guardian; and the beneficiary may be any age. New Mexico has an unwritten policy that does not allow people over age 65 to fund a (d)(4)(C) trust as an exempt transfer. At the death of the beneficiary, the non-profit organization may retain a portion of the trust fund. While the federal statute provides that Medicaid must be reimbursed from the remaining funds before the trust can be disbursed to other remainder beneficiaries, in New Mexico the non-profit trustees have been allowed to retain the entire balance in these accounts after the death of the beneficiary. There are currently three pooled trust arrangements in New Mexico. In Albuquerque, ARCA is the trustee of a pooled trust for its own clients and other people with developmental disabilities and in Santa Fe, the Knights Templar Foundation is a trustee of a pooled trust to benefit the clients of Santa Maria el Mirador. The ARC of New Mexico serves as trustee of a pooled trust that can benefit any disabled person who applies to open an account with them. These pooled trusts have been approved in advance by New Mexico Medicaid.

IV. TRUSTEES OF SPECIAL NEEDS TRUSTS

Trustees of Special Needs Trusts have the same duties as trustees of other trusts. These duties include the duty of loyalty, the duty of care of a prudent person, the duty to observe the terms of the trust agreement, and the duty not to waste or squander the trust assets. However, trustees of a Special Needs Trust have added responsibilities because of the disability of the

beneficiary and the special conditions that apply to distributions from the trust.

A trustee of a Special Needs Trust must develop a working knowledge of the government benefits for which the beneficiary is qualified, because the trustee must understand which distributions are appropriate and which are not. This can mean not making certain distributions, such as cash to an SSI beneficiary, as well as making other distributions, such as purchasing plane tickets. A Special Needs Trust trustee must know the long term care plan for the beneficiary, her life expectancy, and what activities are possible or are reasonable to expect. A trustee of a Special Needs Trust should be creative in anticipating activities or items that will enhance the beneficiary's life. For example, a beneficiary who is totally physically disabled, and who requires 24 hour care in a nursing home, but who is not totally mentally disabled, might enjoy a trip to the zoo or to a play. The cost of such a trip may include the cost of a personal companion.

A Special Needs Trust trustee must understand which distributions would jeopardize the benefits being received. For example, SSI beneficiaries receive cash payments from the Social Security Administration that are deemed to be for the recipients' food and shelter. The receipt of any additional cash, or any item that would be "in-kind support and maintenance," will reduce the monthly SSI benefit, up to a one-third reduction. Therefore, the trustee should not pay the rent for the beneficiary who received SSI without realizing that such a payment may reduce the monthly cash benefit, because that is an in-kind payment for shelter. This is not to say, however, that it might not be prudent for the trustee to pay the rent, even though such payment will result in the reduction of the monthly benefit by one third, because the overall enhancement for the beneficiary might outweigh the reduction in cash.

Although this is not strictly the responsibility of the Trustee, the SSI program requires

periodic reporting for all SSI recipients. Eligibility will be denied if the reports are not complete. The existence of the Special Needs Trust must be reported to the Social Security Administration. Additionally, if the beneficiary changes her address, gets married, obtains more resources or more income, or is no longer disabled, these changes must be reported by the beneficiary. The report is due within 10 days of the end of the month in which the change occurs.

The beneficiary or her agent must respond promptly to any notices received from the Social Security Administration or from Medicaid. If notice is given of a change in benefits that is detrimental to the beneficiary, the beneficiary has 60 days in which to file a written notice of an appeal in order to keep the benefits in place during the appeal process. The beneficiary cannot ignore or postpone dealing with the government agency.

As with many types of trusts, there is good reason to consider having co-trustees of Special Needs Trusts. If the trust holds significant assets, a corporate trustee may be beneficial for long term investment expertise. However, an appropriate family member could be a co-trustee in order for the day-to-day needs of the beneficiary to be monitored. Trustees of Special Needs Trusts often need ongoing legal representation. To the extent possible, the trustee should stay abreast of changes in the law. I recommend an annual review meeting with the trustee and legal counsel.

V. TAX ISSUES

A. Federal Gift Tax

Generally, gifts of any amount to third party-settled Special Needs Trusts with one beneficiary are taxable gifts. The \$13,000 annual exclusion from gift tax rule does not apply to these transfers, because the use of the gift for the beneficiary is postponed into the future. In trusts other than special needs trusts, this problem is often addressed by the use of “Crummey

powers.” A notice is sent to a beneficiary by the trustee giving her a right that exists for a limited time to withdraw the gift. The Crummey power converts the gift from a gift of a future interest to a gift of a present interest, thus making it eligible for the annual exclusion. But, because the beneficiary of a special needs trust cannot be given the authority to demand withdrawal of any amount from the trust at any time, Crummey powers should not be given to her.

If one of the goals of the third party-settled special needs trust is to reduce the federal taxable estate of the donor, one way to solve this problem is to include other family members of the beneficiary as beneficiaries of the trust, with the limitation that if the disabled family member is receiving means-based government benefits, then the corpus of the trust is first to be used for the special needs of the disabled family member. This creates potential donees of the Crummey powers only for the purpose of transferring non-taxable gifts into the trust.

If reducing the federal taxable estate of the donor is not a required goal, the third party-settled trust can be structured as a grantor trust, which keeps the transfers into the trust from being completed, and therefore, taxable gifts. This can be accomplished in several ways. A simple method is to name the grantors as trustees, so that they will retain the power to direct disposition and enjoyment of the trust. An additional method is to give the grantors a testamentary limited power of appointment over the trust.

Self-settled Special Needs Trusts are grantor trusts, because the beneficiary is deemed to be the grantor even though she may not be the formal grantor of the trust. Therefore, a transfer to a self-settled trust by the beneficiary is not a gift at all.

B. Federal Estate Tax

A third party-settled Special Needs Trust will not be included in the federal estate of the grantor, if the third party donor makes a completed gift to the trust. The third party-settled trust

is not includable in the federal estate of the beneficiary, because the beneficiary does not have sufficient control over the trust fund to warrant inclusion, unless the beneficiary is given a general testamentary power of appointment over the trust. There is no reason why a third party-settled trust should not include generation skipping transfer tax exemption planning, especially if it is believed that there will be a large amount of corpus left over after the death of the beneficiary which will pass to other family members and grandchildren.

The self-settled Special Needs Trust will be included in the beneficiary's federal taxable estate, because of the beneficiary's retained interest. However, the Medicaid payback provision may significantly reduce the value of the trust fund, if not eradicate it altogether. Furthermore, careful planning by the trustee can result in distributions from the trust being sufficient to reduce the corpus to avoid federal estate tax as well as to reduce the Medicaid payback.

C. Fiduciary Income Tax

A third party-settled Special Needs Trust which is not a grantor trust should be assigned its own taxpayer identification number. It will file an income tax return for each calendar year, which is due on April 15 of the following year. While the trustee is prohibited from distributing cash directly to the beneficiary, fiduciary income tax rules require that the trustee report as distributable net income the value of all distributions from the trust up to the amount of the net taxable income of the trust for that year. For example, if the trustee distributes funds for the purchase of a vehicle, which is titled in the beneficiary's name, this is an acceptable distribution of funds for an exempt resource. It will not disqualify the beneficiary from SSI or Medicaid as a distribution of income. However, to the extent that the trust had earnings, the distributable net income rules require that the trust report those earnings up to the amount distributed for the value of the vehicle as having been distributed to the beneficiary as income on a Schedule K-1. The

beneficiary will report the income on her individual income tax returns, even though she did not receive the funds in the form of income. The trustee can pay the cost of preparation of the income tax returns and can pay any income tax due directly to the taxing jurisdiction.

A special needs trust is a complex trust. If the trust retains income, it will be the taxpayer for that taxable income. A complex trust may take a \$100 exemption against its taxable income. A new provision to the Internal Revenue Code provides an exception for some special needs trust beneficiaries. 26 USCA section 642(b)(2)(C)(i),(ii). This statute was passed as a part of the Victims of Terrorism Tax Relief Act of January, 2002. It provides for a higher tax exemption if the trust is what is defined as a Qualified Disability Trust (“QDT”), that is, one that is established solely for the benefit of an individual under 65 who is disabled. A trust is a QDT even if a remainder beneficiary is not disabled. The definition does not appear to distinguish a third party-settled trust from a self-settled trust. However, a special needs trust for a person over age 65 that was funded after age 65 would not qualify as a QDT. For a trust that meets the definition of a QDT, the exemption that is allowed for the trust is the allowable personal exemption for the individual beneficiary. In 2009, the personal exemption was \$3,650. Therefore, if a QDT retained \$5,000 of earned income, after taking the exemption amount, it would report \$1,350 taxable income, and pay income tax in a 15% bracket in the amount of \$203. A complex trust that was not a QDT would have had only a \$100 exemption, and thus would have reported \$4,900 taxable income and paid \$995 in tax in a 25% bracket.

If a third party-settled trust is a grantor trust, it does not need to have a tax identification different from the grantor, and the income will be deemed to be distributed and taxable to the grantor. One advantage of a special needs trust being a grantor trust is that the grantors, who are often close family members of the disabled beneficiary, can effectively give more to the

beneficiary by paying the income taxes on the earnings of the trust.

Self-settled Special Needs Trusts are grantor trusts, and therefore, do not need to be assigned a separate taxpayer identification number, but use the Social Security number of the beneficiary. The income and expenses of the trust are reported on the beneficiary's individual income tax returns. In spite of this reality for income tax purposes, it is not uncommon for a different tax identification number to be assigned to a d(4)(A) trust, because the agencies providing the benefits may not understand that the trust is a separate entity from the beneficiary if it uses the Social Security number of the beneficiary.

VI. CONCLUSION

In the United States today, a permanent total disability brings with it economic peril. A person who is born with autism, or who suffers from Alzheimer's, or who has a spinal injury, must address both the critical medical treatment required as well as the loss of economic self-sufficiency. Medical care is extraordinarily expensive and ongoing. Many disabilities necessitate special housing, transportation and education. While many private charities provide worthwhile services, the enormous cost of caring for long term disabled persons in this country is necessarily borne primarily by the government. However, maintaining eligibility for government programs often contradicts the efforts of family members to provide support and care for their loved ones. Special Needs Trusts provide the mechanism for sheltering resources to benefit disabled family members so that these contradictory efforts can be harmonized. A well managed support system using Special Needs Trusts can maximize the use of government-provided services while supporting the family's care and enhancing the comfort and enjoyment of life for the disabled beneficiary.