

# THIRD PARTY SPECIAL NEEDS TRUST

by Thomas D. Begley, Jr.

According to *Business Week Magazine*, one out of every ten people in America has a special needs situation. There is an enormous need for proper estate planning for parents of these disabled persons and a similar need for special needs trusts for persons who have obtained a tort recovery, an inheritance, equitable distribution, child support, or alimony. Done properly these assignments require an interdisciplinary approach, including a life care planner, a financial advisor, an insurance expert, a CPA, a lawyer, corporate trustees, and possibly a structured settlement broker. Why are these trusts important? What are the significant drafting issues and how must the trust be administered.

## 1. PUBLIC BENEFIT PROGRAMS

Special Needs Trusts are necessary to preserve the Beneficiary's public benefits. The principal government benefit programs affecting the disabled are:

- SSI
- Medicaid
- SSD
- Medicare
- Section 8 Housing

### 1.1. SSI

The key issue is whether or not the person is disabled. For SSI and Medicaid purposes disability is defined as "an individual shall be considered to be disabled for purposes of this subchapter if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than twelve months. The impairment must be so severe that the claimant is unable to do his or her previous work or any other "substantial gainful activity" which exists in the national economy."<sup>1</sup> A child under the age of 18 is considered disabled if the child has a medically determinable physical or mental impairment that results in "marked and severe functional limitation."<sup>2</sup>

Substantial gainful activity (SGA) for a disabled person is the ability to earn \$830 per month in the workplace effective January 2005. For a blind person SGA is \$1,380. This is indexed for inflation. In the future SGA will be determined by the ratio of the national average wage index for the previous two years; comparing that amount to the current SGA level and taking the greater of the two.<sup>3</sup>

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<sup>1</sup> 42 U.S.C. §1382c(a)(3)(A) and (B).

<sup>2</sup> 42 U.S.C. §1382c(a)(3)(C).

<sup>3</sup> 69 Fed. Reg. 62497 (Oct. 26, 2004).

Supplemental Security Income (SSI) is a means-based federal program that provides income to certain aged, blind, and disabled persons. The program is administered by the Social Security Administration (SSA). The law is found at 42 U.S.C. § 1381 *et seq.* Regulations are found in Title 20 Part 416 of the code of Federal Regulations (CFR). Operating procedures can be found in the Program Operating Manual System (POMS).<sup>4</sup> While the POMS are not legally binding, they carry great weight.

### **1.1.1. Benefits**

SSI is an income maintenance program for poor people. The purpose of the SSI payment is to provide the recipient with income to be used for food and shelter.<sup>5</sup> It is designed to provide recipients with 75% of the federally defined poverty level. For 2005, the maximum federal SSI monthly payment for an individual is \$579 per month.<sup>6</sup> For a couple, the maximum monthly payment is \$869.<sup>7</sup> This is known as the Federal Benefit Rate. Many states provide a small supplement to the federal benefit. Any countable income paid to the recipient is deducted from the basic federal SSI payment. Income is countable whether earned or unearned, and certain in-kind assistance is also deemed as income.<sup>8</sup>

### **1.1.2. Eligibility**

There are five eligibility requirements for SSI:

- (1) Categorical
- (2) Residence
- (3) Financial
- (4) Application for other benefits
- (5) Non-Institutionalization

#### **1.1.2.1. Categorical**

An applicant for SSI must be at least 65 years of age, blind, or disabled.<sup>9</sup>

#### **1.1.2.2. Residence and Citizenship**

An SSI recipient must be a citizen of the United States or meet the eligibility requirements of the 1996 Welfare Act and the Balanced Budget Act of 1997. For SSI purposes a citizen of the United States is a person born in the United States, Puerto Rico, Guam, or the Virgin Islands. Persons born in American Samoa, Swains Island, and the Northern Marianas Islands are U.S. nationals, but are treated as U.S. citizens for SSI purposes.<sup>10</sup> U.S. citizenship may also be obtained through the naturalization process. Certain non-citizens are also eligible.

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<sup>4</sup> The POMS are available at [www.ssa.gov](http://www.ssa.gov).

<sup>5</sup> 20 C.F.R. §416.110.

<sup>6</sup> 42 U.S.C. §1382f(a); 69 Fed. Reg. 62497 (Oct. 26, 2004)

<sup>7</sup> *Id.*

<sup>8</sup> 20 C.F.R. §416.1102.

<sup>9</sup> 42 U.S.C. §1382c(a)(1)(A).

<sup>10</sup> 20 C.F.R. § 416.1610

### **1.1.2.3. Financial**

SSI is a means-tested program and SSI recipients must first meet financial tests.

#### **1.1.2.3.1. Income**

SSI categorizes income as countable and non-countable, earned or unearned, and cash or in-kind. The first \$20 of most income received in a month is disregarded. Income is defined as “anything a person receives in cash or in-kind that can be used to meet a person’s needs for food or shelter.”<sup>11</sup> Certain items cannot be used for food and shelter and are, therefore, not counted as income.<sup>12</sup> Receipt of cash income reduces SSI payments dollar-for-dollar.

As a general rule, anything of value received during the month is considered income for the month received and a resource as of the first day of the following month.

Income of certain persons is deemed to certain SSI applicants. These include the following:

- Children under 18 living with one or more parents who are not eligible for SSI;
- An SSI applicant living with a spouse who is not eligible for SSI;
- An SSI applicant who is an alien (the income of the sponsor is deemed in certain cases); and
- An SSI applicant who lives with an essential person. An essential person is someone who is caring for a disabled individual and is seen as essential to care and prevention of institutionalization. Essential persons were grandfathered into the SSI program from the pre-existing state disability program. There is no separate category in the SSI program for essential persons.

Certain types of income are excluded from deeming:

- Spousal and parental exclusions;<sup>13</sup>
- Essential person or sponsor exclusions;<sup>14</sup>
- Ineligible child exclusions;<sup>15</sup>
- Eligible alien exclusions;<sup>16</sup>

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<sup>11</sup> 20 C.F.R. §416.1102; 70 Fed. Reg. 6340 (Feb. 7, 2005).

<sup>12</sup> These are found at 20 C.F.R. §416.1103; 70 Fed. Reg. 6340 (Feb. 7, 2005).

<sup>13</sup> 20 C.F.R. § 416.1161(a)

<sup>14</sup> 20 C.F.R. § 416.1161(b)

<sup>15</sup> 20 C.F.R. § 416.1161(c).

<sup>16</sup> 20 C.F.R. § 416.1161(d).

Distributions from trusts are considered income to the recipient. Therefore, trustees should make distributions directly to third party providers for goods and services.

#### **1.1.2.3.1.1. Earned Income**

Earned income is defined as wages before deductions and net earnings from self-employment.<sup>17</sup> There are certain exclusions from earned income, including federal assistance payments; \$30 per quarter of infrequent income; \$65 plus one-half of remaining income per month.<sup>18</sup> For 2005, a blind or disabled child regularly attending school may earn up to \$1,410 per month of earned income with a maximum of \$5,670 per calendar year.<sup>19</sup>

#### **1.1.2.3.1.2. Unearned Income**

Unearned income is defined as all income that is not earned.<sup>20</sup> Examples of unearned income include interest, dividends, alimony, annuities, pensions, and inheritances. Exclusions from unearned income are limited to tuition scholarships, \$60 per quarter of infrequent income, and one-third of child support payments to the disabled child.

All interest and dividend income on countable resources is excluded. Gifts received that are used for paying tuition or educational expenses are excluded from income in addition to grants, scholarships, and fellowships used to pay educational expenses.<sup>21</sup>

#### **1.1.2.3.1.3. ISM Rules**

In-kind Support and Maintenance (ISM) is the receipt of food or shelter furnished by a third party.<sup>22</sup> This will reduce a recipient's benefits<sup>23</sup> because SSI benefits are specifically intended to pay for a person's food and shelter and if a person receives food and shelter from another source, the less SSI benefits are needed. The reduction of SSI benefits for ISM is not on a dollar-for-dollar basis as with cash. A recipient's living arrangements determine whether in-kind support and maintenance is valued by the one-third reduction rule or the presumed-value rule. If a recipient lives in the household of another, the SSI benefit would be reduced by one-third.<sup>24</sup> However, there is no reduction if the recipient pays a pro rata share of the food or shelter expenses.<sup>25</sup>

Where the recipient lives in his or her own household, the presumed-value rule applies.<sup>26</sup> This means that that the payment is reduced by one-third of the benefit rate plus \$20.

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<sup>17</sup> 42 U.S.C. §1382a(a); 20 C.F.R. §416.1110.

<sup>18</sup> 20 C.F.R. §416.1112(b), (c).

<sup>19</sup> 69 Fed. Reg. 62497 (Oct. 26, 2004).

<sup>20</sup> 42 U.S.C. §1382a(a)(2); 20 C.F.R. §416.1120.

<sup>21</sup> 20 CFR §416.1124(c)(3).

<sup>22</sup> 20 CFR §416.1130(b); 70 Fed. Reg. 6340 (Feb. 7, 2005).

<sup>23</sup> 20 CFR §§416.1100, 416.1130(b).

<sup>24</sup> 42 U.S.C. §1382a(a)2(A); 20 C.F.R. §416.1131.

<sup>25</sup> 20 C.F.R. §416.1133(a).

<sup>26</sup> 20.C.F.R. §416.1140.

The Social Security Administration has recently adopted rules so that clothing would no longer be counted as income.<sup>27</sup> Under the proposed regulation income would be defined as “income is anything you receive in cash or in-kind that you can use to meet your needs for food and shelter.”

#### **1.1.2.3.1.4. Deeming of Income**

Income of an ineligible spouse or ineligible parent or sponsor of an alien is deemed to the SSI applicant.<sup>28</sup> Living arrangements determine when deeming occurs. If the claimant lives in the same household as the ineligible spouse or parent, deeming will occur. This means that in calculating the income of the SSI applicant, some of the income of the ineligible spouse or parent living in the same household may be attributed to the SSI applicant. Income from the sponsor or an alien is deemed to the SSI applicant, even if a residence is not shared.<sup>29</sup> If a child under 18 lives in the household of a parent, the income of the parent is deemed to the child.<sup>30</sup> This is why children under 18 seldom receive SSI payments unless their parents have income below the poverty line. Once a child reaches 18, the income of the parent is no longer deemed to the child.

#### **1.1.2.3.1.5. Loan Proceeds**

Loan proceeds are not countable as income for SSI purposes.

#### **1.1.2.3.1.6. Third Party Settlements, Inheritances, and Gifts**

Receipt of third party settlements, inheritances, and gifts are considered income in the month received and should result in ineligibility for that month.<sup>31</sup> Constructive receipt is considered receipt.<sup>32</sup> On the first day of the following month, such monies are considered a resource, which may cause a loss of eligibility. A disclaimer by the disabled person does not avoid constructive receipt as to income, but should solve the eligibility problem related to resources.

### **1.1.2.3.2. Resources**

#### **1.1.2.3.2.1. General**

As a general rule, the countable resources of a single person cannot exceed \$2,000, and the countable resources of a married couple cannot exceed \$3,000 if they are living together.<sup>33</sup> Resources means cash or other liquid assets, or any real or personal property that a person or his

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<sup>27</sup> 70 Fed. Reg. 6430 (Feb. 7, 2005).

<sup>28</sup> 20 C.F.R. §416.1160(a).

<sup>29</sup> 8 U.S.C. §1631.

<sup>30</sup> 20 C.F.R. §§1160(a), 416.1165(g)(7).

<sup>31</sup> 42 U.S.C. §1382a(a)(2); 20 C.F.R. §416.1121.

<sup>32</sup> Social Security Ruling (SSR) 97-1p (Mar. 28, 1997).

<sup>33</sup> 20 C.F.R. §416.1205(c).

or her spouse own and can convert to cash for support and maintenance.<sup>34</sup> An inheritance becomes income when under state law it can be converted to cash.

#### **1.1.2.3.2.2. Deeming**

As with income, resources are deemed. Living arrangements determine the deeming of resources. A person living with an ineligible spouse has the resources of the ineligible spouse deemed to herself. A child under 18 years of age living with an ineligible parent suffers the same result. However, upon the child attaining 18, the resources of the parent are no longer deemed to the child living in the household of a parent. Similarly, resources of an alien's sponsor in excess of \$2,000 for an individual, \$3,000 for a couple are deemed to the alien.

#### **1.1.2.3.2.3. Non-Countable Resources**

Certain resources are non-countable.<sup>35</sup> These include:

- The individual's home, if it is occupied by the individual as his or her principal residence or, if the person is institutionalized, if the home is occupied by the spouse, or by a child under 21 blind or disabled;<sup>36</sup>
- Household goods will not be resources if they are:
  - (i) items of personal property, found in or near the home, that are used on a regular basis; or
  - (ii) items needed by the household or for maintenance, use and occupancy of the premises as a home.

Such items include but are not limited to: Furniture, appliances, electronic equipment (such as personal computers and television sets), carpets, cooking and eating utensils, and dishes.

Personal effects will not be counted as resources if they are:<sup>37</sup>

- (i) items of personal property ordinarily worn or carried by the individual; or
- (ii) Articles otherwise having an intimate relation to the individual.

Such items include but are not limited to: personal jewelry (including wedding and engagement rings), personal care items, prosthetic devices, and educational or recreational items (such as books or musical instruments). Also not counted as resources are items of cultural or

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<sup>34</sup> 20 C.F.R. §416.1201(a).

<sup>35</sup> 42 U.S.C. §1382b(a); 20 C.F.R. §416.1210.

<sup>36</sup> 42 U.S.C. §1382b(a); 20 C.F.R. §§416.1210, 416.1212.

<sup>37</sup> *Id.*

religious significance to an individual and items required because of an individual's impairment.

SSA will continue to count as resources items that were acquired or are held for their value as an investment, because SSA does not consider these to be personal effects. Such items can include but are not limited to: Gems, jewelry that is not worn or held for family significance, or collectibles;<sup>38</sup>

- One automobile, regardless of value, if it is used for transportation for the individual or a member of the individual's household;<sup>39</sup>
- The cash values of life insurance policies are excluded if the face value does not exceed \$1,500 on all such policies; and
- Burial plot and funds for burial up to \$1,500 per individual are also excluded.
- Assets held in a Uniform Gifts to Minors Act account (UGMA). Assets held in a UGMA account cannot be used by the custodian for his or her own personal benefit and are not his or her resources. Income on the account is not treated as income to the custodian for the same reason. Assets in the custodian account are not considered resources of the minor until such time as the minor reaches majority. Income is not income to the minor. However, disbursements to the minor by the custodian for the benefit of the minor may be income to the minor if used for food or shelter.<sup>40</sup>

#### **1.1.2.3.2.4. Lump Sum Payments**

There are two types of payments that are excluded from being counted as resources for a specified period of time.

- *Retroactive SSI and SSD Payments.* Retroactive SSI and SSD payments are excluded from being counted as resources for a period of 6 months from the date of receipt.<sup>41</sup>

If the retroactive SSI payments are paid to an adult and are at least 12 times the maximum monthly payment, including the state supplement, the retroactive benefit will be paid in up to 3 installments, 6 months apart. The first installment will be 12 months of retroactive benefit, the second installment another 12 months, and the third installment will be the

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<sup>38</sup> 70 Fed. Reg. 6340 (Feb. 7, 2005).

<sup>39</sup> *Id.*

<sup>40</sup> POMS §S.I. 01120.205.

<sup>41</sup> 42 U.S.C. § 1382b(a)(7); 20 C.F.R. § 416.1233(a)

remainder, if any. This procedure is designed to not force the recipient to needlessly spend the retroactive benefit in 6 months. The recipient can request a larger portion of the retro benefit paid at the beginning, or all at once, if a specific need or debt can be shown that would override the installment procedure.

Children receiving retroactive benefits must place the benefit in a special detailed account with restrictive distributions.<sup>42</sup>

If the retroactive benefit is used to purchase a non-countable resource, that resource will be included as of the date of purchase.

The SSI retroactive lump sum payment will *not* be counted as income in the month received. The SSD retroactive lump sum payment will be counted as income in the month it is received.

- *Proceeds of sale of home.* The proceeds from the sale of a principal residence will not be counted as a resource for 3 months. Any portion of the proceeds used to purchase a new residence in that time will not be counted as a resource at all.
- *Other Lump Sum Payments.* Other lump sum payments will always be treated as income in the month received and then will be counted as a resource if it is retained as a countable resource into the following month. There are 3 exceptions:
  - They are used to purchase exempt resources
  - They are used to pay for services or repairs
  - They are transferred to a third party

#### **1.1.2.4. Application for Other Benefits**

A person must file an application for SSI benefits and any other benefits to which the person may be entitled.<sup>43</sup> Receipt of the other benefits will reduce or eliminate the SSI benefit on a dollar-for-dollar basis. Some disabled persons can receive SSI and Medicaid, as well as SSD and Medicare. For this combination to occur, the SSD payment must be lower than the SSI benefit that the individual would have received if he or she were not also eligible for SSD.

#### **1.1.2.5. Non-Institutional**

Residents of public institutions are ineligible for SSI. These are public institutions controlled by a governmental entity that provide treatment or services in addition to food and

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<sup>42</sup> POMS S.I. 01130.601

<sup>43</sup> 42 U.S.C. §1382(e)(2); 20 C.F.R. §§416.210(a), (b).

shelter to four or more persons.<sup>44</sup> Typical public institutions rendering residents ineligible for SSI are state mental institutions and prisons.

### **1.1.2.6. Fugitives and Parole Violators**

Persons who are fugitive felons or violating a condition of parole or probation are not eligible for SSI.<sup>45</sup>

### **1.1.3. Transfer of Resources**

Pursuant to the Foster Care Independence Act of 1999 (FCIA 99),<sup>46</sup> penalties were imposed for SSI purposes on transfers of assets. The penalties are effective for transfers occurring on or after December 14, 1999.<sup>47</sup>

Resource determinations are based on the resources an individual owns on the first moment of the month. Therefore, the effective date of the transfer is the first day of the month following the transfer.<sup>48</sup>

If an SSI recipient or spouse of an SSI recipient disposes of resources for less than fair market value during a 36-month lookback period,<sup>49</sup> the individual is ineligible for benefits for a period of time. The period is calculated by dividing the uncompensated value of the transfer by the amount of the maximum monthly benefit payable, including any state supplement.<sup>50</sup> The penalty is rounded to the nearest whole number with a cap of 36 months.<sup>51</sup> The penalty begins on the first month in or after which resources were transferred that does not occur during any other period of ineligibility.<sup>52</sup>

The transfer rules do not apply to transfers made by a deemor unless the deemor is a co-owner of the resource or is the ineligible spouse.<sup>53</sup> Therefore, if a child is receiving SSI and the parent whose resources are deemed to the child transfers those resources, the transfer penalty does not apply to the child.

The exemptions from the SSI transfer penalty track the Medicaid penalty exemptions. They include: transfers between spouses<sup>54</sup>; transfers “for the sole benefit of” the spouse<sup>55</sup>; transfers to a trust established solely for the benefit of the transferor’s child who is blind or disabled<sup>56</sup>; and transfers to (d)(4)(A) and (C) trusts.<sup>57</sup> As in Medicaid planning, transfer of a

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<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> H.R. 1802, 106<sup>th</sup> Congress.

<sup>47</sup> *Id.* and POMS §S.I. 01150.110.

<sup>48</sup> POMS §S.I. 01150.001.B.2.

<sup>49</sup> H.R. 3443 Foster Care Independence Act of 1999 §206(c)(ii)(I).

<sup>50</sup> *Id.* at §206(iv).

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at §206(iii).

<sup>53</sup> POMS §S.I. 01150.110 E.

<sup>54</sup> H.R. 3443 Foster Care Independence Act of 1999 §206(c)(C)(ii)(I).

<sup>55</sup> *Id.* at §206(c)(C)(ii)(II).

<sup>56</sup> *Id.* at §206(c)(C)(ii)(III).

home to a spouse,<sup>58</sup> a minor or disabled child,<sup>59</sup> a sibling who has an equity interest and has lived in the home for at least one year,<sup>60</sup> and a caregiver child<sup>61</sup> are all exempt.

The transfer penalty may be waived under circumstances similar to Medicare waiver, i.e., the recipient intended to dispose of the assets at fair market value,<sup>62</sup> the transfer was made exclusively for purposes other than to qualify for SSI,<sup>63</sup> all of the transferred assets are returned,<sup>64</sup> or undue hardship.<sup>65</sup> Note that in Medicaid planning, a penalty is reduced if there is a partial return of assets. Under the statute for SSI, *all* of the assets must be returned. The law is effective December 14, 1999.

The statute also tracks the Medicaid rules concerning jointly owned assets. A resource held by an individual in common with another person or persons in a joint tenancy, tenancy in common, or similar arrangement, is deemed disposed of by the individual when an action is taken, either by the individual or by another person, that reduces or eliminates the individual's ownership or control of such resource.<sup>66</sup>

Jointly owned bank accounts are assumed to be owned entirely by the SSI recipient.

There is no penalty if the transfer is made for market value. Fair market compensation may be in the form of services to be provided to the recipient at a future time, although the contract should be in writing and be commercially reasonable.

On May 26, 2000 Emergency Transmittal EM-00067 was issued by the Social Security Administration explaining the treatment of claims involving trusts. On August 23, 2000 a new POMS section was issued regarding transfers of assets for less than fair market value.<sup>67</sup> There had been a question as to whether a transfer of a countable asset during the month in which it was received would be considered a transfer of income and, therefore, exempt under the SSI transfer provisions. However, it is now clear that the transferred asset for less than fair market value will result in the imposition of a period of ineligibility.<sup>68</sup>

Transfers of an inheritance in the month it is received is a transfer of a resource. Although normally it is not considered a resource until the first day of the month following the date of its receipt, an inheritance meets the definition of a resource the moment after it is received.<sup>69</sup>

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<sup>57</sup> *Id.* at §206(c)(C)(ii)(IV).

<sup>58</sup> *Id.* at §206(c)(C)(i)(I).

<sup>59</sup> *Id.* at §206(c)(C)(i)(II).

<sup>60</sup> *Id.* at §206(c)(C)(i)(III).

<sup>61</sup> *Id.* at §206(c)(C)(i)(IV).

<sup>62</sup> *Id.* at §206(c)(C)(iii)(I).

<sup>63</sup> *Id.* at §206(c)(C)(iii)(II).

<sup>64</sup> *Id.* at §206(c)(C)(iii)(III).

<sup>65</sup> *Id.* at §206(c)(C)(iv).

<sup>66</sup> *Id.* at §206(c)(D).

<sup>67</sup> POMS §S.I. 01150.SSA Pub. No. 68-0501150, Sept. 2000.

<sup>68</sup> POMS §S.I. 01150.110.

<sup>69</sup> POMS §S.I. 01150.001.B.5.

The SSA is required to notify state Medicaid agencies about transfers of resources.<sup>70</sup>

An interesting difference between the Medicaid rules and the SSI rules is that there is a three-year lookback for transfers to individuals under both SSI and Medicaid. There is a five-year lookback to transfers to trusts under Medicaid, but only a three-year lookback for transfers to a trust under SSI.

In many states a Medicaid transfer penalty that results in a fractional month is rounded down. Under SSI rules the fractional month is rounded up or down. The rounding is to the nearest whole month. If the spouse of an SSI recipient makes a testamentary transfer, is there an SSI transfer penalty?

## **1.2. Medicaid**

Generally, Medicaid is a welfare program that pays medical bills for the aged, blind, and disabled who meet certain requirements. It is a medical payment program, not a medical insurance program. Medicaid is means-based with both income and resource testing. The Medicaid law is Title XIX of the Social Security Act and is found at 42 U.S.C. §1396 and 42 C.F.R. Parts 430, 431, and 435.

Medicaid pays for a very broad spectrum of medical services including hospital stays, physician services, community-based health care and nursing services, and prescriptions. It also pays certain housing costs, and for some, vocational and employment services and transportation. There are no deductibles, co-payments, or financial limits on coverage. Coverage varies from state to state. The state laws must be written within certain parameters prescribed by federal law. In some states, eligibility is based on the eligibility requirements for Supplemental Security Income (SSI).<sup>71</sup> These states are called SSI states.

In the so-called “SSI States,” states have entered into a contract under Section 1634 of the Social Security Act to which the Social Security Administration (SSA) determines Medicaid eligibility for the aged, blind and disabled individuals. The SSA determination is generally held to be final for SSI and Medicaid eligibility. Colorado recently attempted to employ independent Medicaid eligibility standards for beneficiaries of trusts who were SSI recipients. The 10<sup>th</sup> Circuit<sup>72</sup> held that in a 1634 state the State Medicaid Agency is required to make Medicaid assistance available to all recipients of SSI benefits and that the state is prohibited from employing any independent Medicaid eligibility standards to deny or terminate Medicaid benefits to an SSI recipient who is the beneficiary of a trust. In a subsequent case, the Colorado Supreme Court acknowledged the Remy decision.<sup>73</sup> The court held that the Colorado Medicaid Department's practice of independently reviewing the trusts of SSI recipients to determine Medicaid eligibility was invalid, and that SSI recipients were automatically eligible for

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<sup>70</sup> POMS §S.I. 01150.001.C.3.

<sup>71</sup> The SSI states are Alabama, Alaska, Arizona, Arkansas, California, Colorado, Delaware, District of Columbia, Florida, Georgia, Idaho, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, Montana, Nevada, New Jersey New Mexico, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Vermont, Washington, West Virginia, Wisconsin, and Wyoming.

<sup>72</sup> Remy v. Reinerston, 268 F.3d 955 (CA 10, 2001).

<sup>73</sup> Stell v. Boulder County Department of Social Services, 92 P.3d 910 (S. Ct. CO, 2004).

Medicaid. Nevertheless, the issue remains alive in Mississippi, New Mexico and several other states.

Other states are known as section 209(b) states.<sup>74</sup> Section 209(b) states can adopt Medicaid eligibility requirements that can be more restrictive than the SSI federal eligibility requirements.<sup>75</sup> These states may use stricter definitions of aged, blind, or disabled, or may have tighter standards for financial need.<sup>76</sup> However, the state rules may be no more restrictive than those in effect under the state's Medicaid plan as of January 1, 1972, nor more liberal than those used for determining optional coverage of SSI beneficiaries.<sup>77</sup>

### **1.3. Section 8 Housing**

#### **1.3.1. Rental Assistance**

Section 8 of the Housing Act of 1937 provides for a rental assistance program for low-income families and individuals.

HUD has recently combined its Voucher Program and Certificate Program.<sup>78</sup> HUD pays rental subsidies so eligible families can afford decent, safe, and sanitary housing. The programs are generally administered by Public Housing Agencies (PHAs). HUD funds the PHAs. PHAs are no longer allowed to enter into contracts for assistance in the Certificate Program. Only select rental units that meet program housing quality standards can be included in the program. If the PHA approves the family's unit and tenancy, it contracts with the owner to make rent subsidy payments on behalf of the family. In the Voucher Program the rental subsidy is determined by a formula. The subsidy is based on a local "payment standard" that reflects the cost to lease a unit in the local housing market. Generally the family pays 30% of adjusted monthly income for rent. If the rent is less than the payment standard, the family pays less. If the rent is more, the family pays more.

Section 8 Housing may be "tenant-based" or "project-based." In "project-based" programs, rental assistance is paid for families who live in specific projects or units. "Tenant-based" assistance is paid to units selected by the family.<sup>79</sup>

Unlike section 202 housing where assistance is targeted to a specific project, section 8 rental housing can be theoretically used anywhere. In Section 202 housing, all residents living in the project were eligible for assistance. Tenants paid 30% of their income for rent. When a tenant left the project, the assistance was no longer available. This tended to create ghettos occupied only by those in poverty. HUD has revised its policies so that rental assistance is now provided to tenants rather than projects. This change is meant to scatter the low-income

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<sup>74</sup> The section 209(b) state are Connecticut, Hawaii, Illinois, Indiana, Minnesota, Missouri, Nebraska, New Hampshire, North Carolina, North Dakota, Ohio, Oklahoma, and Virginia.

<sup>75</sup> 42 U.S.C. §1396a(f); 42 C.F.R. §435.121(a); §209(b) or the 1972 Amendments to the Social Security Act Pub. L. No. 92-603, §209(b), 86 Stat. 1329, 1381 (1972).

<sup>76</sup> 42 C.F.R. §435.121(a).

<sup>77</sup> 42 C.F.R. §435.121a(2).

<sup>78</sup> 64 Fed. Reg 43613-01.

<sup>79</sup> 24 C.F.R. §982.1(b).

residents throughout the community and to mix them in with medium- and higher-income residents.

Unfortunately, the Section 8 Housing program has not been as successful as hoped for in spreading low-income residents throughout communities. The landlord must be willing to accept Section 8 tenants. The result is often that the landlord will accept Section 8 tenants in the entire building and then the entire building tends to become filled with Section 8 tenants. Certain sections of cities tend to become magnets for Section 8 Housing and Section 8 tenants are concentrated in these areas.

Generally, the applicant must be a “family,” must be income-eligible, and must be a citizen or non-citizen who has eligible immigration status.<sup>80</sup>

#### **1.3.1.1. Income Eligibility**

As a general rule the income of an applicant for Section 8 Housing may not exceed 50 to 80% of the median income in the area adjusted for family size. Countable income includes: Social Security and Disability benefits, pensions, annuities, alimony, and some welfare payments and regular contributions from others.<sup>81</sup> Non-countable income includes: temporary, one-time, or infrequent income, including gifts, reimbursements for medical expenses, and lump-sum acquisitions, such as inheritances, insurance payments, and capital gains.<sup>82</sup>

While there is no resource test for Section 8 Housing, income is imputed if the applicant’s assets exceed \$5,000. Income would be imputed at the larger of the actual income or the HUD-determined present passbook savings rate.<sup>83</sup> If the family’s assets are \$5,000 or less, the actual income that the family receives from the assets is included. If the family’s assets are more than \$5,000, then the amount of income included is the actual income from assets or a percentage of the value of family assets based on the current passbook savings rate as established by HUD. Currently, the passbook rate is 2%.<sup>84</sup>

Income limits are based on family size based on the annual income the family receives. Various programs have various income limits. There are four income categories: below market interest rate (BMIR), low-income limit, very low-income limit, and extremely low-income limit. They are based on the median income for the area.

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<sup>80</sup> 24 C.F.R. §982.201(a).

<sup>81</sup> 24 C.F.R. §5.609(b).

<sup>82</sup> 24 C.F.R. §5.609.

<sup>83</sup> 24 C.F.R. §5.609(b)(3).

<sup>84</sup> Occupancy Requirements of Subsidized Multi Family Housing Programs, 5.7 F 1 b, [www.hudclips.org](http://www.hudclips.org) (Dec. 10, 2004).

<i>Income Limit</i>	<i>Median Income for the Area</i>
BMIR Income Limit	95%
Low-Income Limit	80%
Very Low-Income Limit	50%
Extremely Low-Income Limit	30%

The extremely low-income limit is not used to determine eligibility, but is rather used for income targeting. The larger the family, the higher the income limit.

### **1.3.1.2. Income from Trusts**

Whether or not income from trusts is included depends upon the Section 8 applicant's access to either income or principal.<sup>85</sup> If the trust is revocable, it is considered accessible and is countable.<sup>86</sup> If the trust is non-revocable and the income is currently available to the family member, the income is countable. But the principal would not be included in calculating income from assets if the actual income is less than the income otherwise imputed. If no family member has access to income or principal, the trust is not included in the calculation of income from assets or in annual income.<sup>87</sup>

If the tenant establishes a non-revocable trust for the benefit of a third party, the trust is considered as an asset disposed of for less than fair market value.<sup>88</sup>

If the tenant establishes a non-revocable trust but reserves the right to income, the income is added to annual income and the principal is counted as an asset disposed of for less than fair market value.<sup>89</sup>

If principal is paid from the trust on a periodic basis to a Section 8 tenant, the payments are considered regular income and are counted as annual income.

If a special needs trust is established by a third party and the tenant does not have access to income, it is not counted as income. However, if income from the trust is paid to the beneficiary regularly, those payments are counted as income.<sup>90</sup>

### **1.3.1.3. Transfer Rules**

While HUD has no transfer penalty per se, it continues to impute income to an individual from the individual's transferred resources based upon the current passbook savings rate as determined by HUD. The reason is that in determining annual income HUD looks at "net family

<sup>85</sup> *Id.* at 5.7 G 1 b (1).

<sup>86</sup> *Id.* at 5.7 G 1 b (2).

<sup>87</sup> *Id.* at 5.7 G 1 b (3).

<sup>88</sup> *Id.* at 5.7 G 1 b (2).

<sup>89</sup> *Id.* at 5.7 G 1 b (3).

<sup>90</sup> *Id.* at 5.7 G 1 c A (2).

assets in excess of \$5,000,”<sup>91</sup> includes the greater of the actual income derived from all net family assets or a percentage of the value of such assets based on the current passbook savings rate as determined by HUD.<sup>92</sup> In determining net family assets, assets disposed of for less than fair market value during the two (2) years preceding the date of the application are included.<sup>93</sup>

In cases of an irrevocable trust not controlled by a member of the family or household, trust assets are not considered as asset.<sup>94</sup> However, income distributed from the trust fund shall be counted when determining annual income under Section 5.609.<sup>95</sup>

Assets placed in a non-revocable trust are considered as assets disposed of for less than fair market value, except when assets placed in trust are received through settlements or judgments.<sup>96</sup>

## **2. DRAFTING THE SPECIAL NEEDS TRUST**

### **2.1. Two Types of Special Needs Trusts**

#### **2.1.1. Third Party Trusts**

The first type is a third party special needs trust, which is established by the third party with assets of the third party for the benefit of a disabled person. Typically, these trusts are established by a parent for the benefit of a disabled child. There is no requirement that the state Medicaid agency be paid back funds on the death of the beneficiary. However, as discussed below, the income from the trust must not be considered available to the beneficiary or the income may push the beneficiary over the public benefit income limit and disqualify the beneficiary from receiving the benefits. Similarly, the assets in the trust must not be available to the beneficiary. There is great flexibility in structuring the trust to achieve the income gift and estate tax goals of the settlor.

There is no federal statutory authority for a third party special needs trust. However, authority is found in the POMS at POMS §SI 01120.200 *et seq.*

#### **2.1.2. Self-Settled Trusts**

The federal statutory authority for a self-settled special needs trust is found at 42 U.S.C. §1396p(d)(4)(A) and at HR 3443 Foster Care Independence Act of 1999 §205.<sup>97</sup>

A self-settled special needs trust, commonly referred to as a (d)(4)(A) trust, is established with the assets of the disabled person. It must be established by the parent, grandparent,

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<sup>91</sup> 24 C.F.R. §5.609(a).

<sup>92</sup> *Id.* at (3).

<sup>93</sup> 24 C.F.R. §5.603(b)(3).

<sup>94</sup> 24 C.F.R. §5.603(b)(2).

<sup>95</sup> *Id.*

<sup>96</sup> Occupancy Requirements of Subsidized Multi Family Housing Programs, 5.7 G 6, [www.hudclips.org](http://www.hudclips.org) (Dec. 10, 2004).

<sup>97</sup> 42 U.S.C. §1382(b).

guardian of the disabled person, or by a court. Only the disabled person can be the beneficiary of the trust. These trusts are frequently used when an injured party receives money as a result of a tort action. The trust must be an inter vivos trust, rather than a testamentary trust, and it must be irrevocable. Prior to establishing the trust the attorney must be concerned with the existence of any Medicare claim and Medicaid lien as well as claims for reimbursement from third party liability insurers. The trust cannot be established if the beneficiary is over age 65. On the death of the beneficiary assets remaining in the trust must be used to pay back any state Medicaid agency providing benefits. There is considerably less flexibility with respect to achieving tax goals.

**Table 1**  
**Special Needs Trust Comparison**

<i>Issue</i>	<i>Third Party SNT</i>	<i>Self-Settled SNT</i>
Established By	Third Party	Parent, Grandparent, Guardian, or Court
Funded by Assets of	Third Party	Disabled Person
Beneficiary	Disabled Person and Non-disabled Person	Disabled Person Only
Grantor Trustee	Yes	No
Discretionary	Yes	Yes
Inter Vivos	Yes	Yes
Testamentary	Yes	No
Revocable	Can Be	No
Grantor Trust	Can Be	Yes
Gift Tax Annual Exclusion	Can Use	Cannot Use
Estate Tax	Can Be Excluded	Includable
Distributions	Payments to Third Parties	Payments to Third Parties
Disability	SSA Definition	SSA Definition
Pay Back Provision	No	Yes
Medicare Claim	No	Yes
Medicaid Lien	No	Yes
Age Limit	None	65

Both third party special needs trusts and self-settled special needs trusts have certain common requirements.

Special Needs Trusts are used to supplement the beneficiary's lifestyle rather than to supplant public benefits. The public benefits typically involved include SSD, Medicare, and free

public education which are not means-tested, and SSI, Medicaid, Section 8 Housing, and other state social services which are means-tested. By establishing a special needs trust, the funds in the trust are made “unavailable” and do not affect the means-tested programs. There is no need for a special needs trust if means-tested programs are not anticipated. While some states provide social services without regard to financial need, other charge disabled people with means for the benefits provided.

Other programs typically involved which might require a special needs trust to retain benefit eligibility include food stamps, Energy Assistance, Vocational Rehabilitation Programs, Recreational Programs, Developmental Disabilities Programs, etc. Additionally, there may be state “waiver” programs or medical or related services in given states.

### **2.1.3. Disability**

The definition of disability for Special Needs Trusts is the same definition contained in the Social Security Act for determining eligibility for SSI or SSD.

## **2.2. POMS Considerations When Drafting a Special Needs Trust**

A special needs trust requires a design that takes into consideration the Program Operations Manual System (POMS), which is published by the Social Security Administration (SSA) and contains the operating procedures for SSI. The POMS recognize the trust device. In fact, the POMS contain the following definition of a trust: “A trust is a property interest whereby property is held by an individual or entity (such as a bank) called the Trustee, subject to a fiduciary duty to use the property for the benefit of another (the beneficiary).”<sup>98</sup>

SSA Transmittal No. 35 dated February 2001 contains a number of important definitions in addition to the definition of trust.<sup>99</sup>

### **2.2.1. Grantor**

A grantor (also called a settlor or trustor) is the individual who provides the trust principal (or corpus).<sup>100</sup>

### **2.2.2. Trustee**

A trustee is a person or entity who holds legal title to property for use of the benefit of another. In most instances the trustee has no legal right to revoke the trust or use the property for his/her own benefit.<sup>101</sup>

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<sup>98</sup> Social Security Administration Program Operations Manual System (POMS) §S.I. 01120.200.B.1.

<sup>99</sup> POMS §S.I. 01120.200 B.

<sup>100</sup> POMS §S.I. 01120.200 B 2.

<sup>101</sup> POMS §S.I. 01120.200 B 3.

### **2.2.3. Trust Beneficiary**

A trust beneficiary is a person for whose benefit a trust exists. A beneficiary does not hold legal title to trust property but does have an equitable ownership interest in it.<sup>102</sup>

### **2.2.4. Grantor Trust**

A grantor trust in which the grantor of the trusts is also the sole beneficiary of the trust.<sup>103</sup>

### **2.2.5. Definition of Discretionary Trust**

The POMS defines a discretionary trust as “a trust in which the trustee has full discretion as to the time, purpose and amount of all distributions. The trustee may pay to or for the benefit of the beneficiary, all or none of the trust as he or she considers appropriate. The beneficiary has no control over the trust.”<sup>104</sup> The key to the entire issue of “availability” is the discretion of the trustee. If the beneficiary has no right to compel distribution or to revoke the trust, the trust is discretionary and the trust assets will be unavailable.

### **2.2.6. Residual Beneficiary**

Whether the trust has named a residual beneficiary is important in some states in determining whether or not the trust is revocable and, therefore, available. A residual beneficiary is defined as “not a current beneficiary of a trust, but will receive the residual benefit of the trust contingent upon the occurrence of a specific event, e.g., the death of the primary beneficiary.”<sup>105</sup>

The Social Security Administration (SSA) follows state law in determining whether or not a trust is revocable. Most states follow the general principle that if a grantor is also the sole beneficiary of the trust, the trust is revocable, but if there is a named “residual beneficiary” then the trust then the trust is irrevocable.<sup>106</sup> Therefore, in a situation where there is a self-settled trust, the grantor is typically the sole beneficiary and a residual beneficiary must be named.

### **2.2.7. Supplemental Needs Trust**

A Supplemental Needs Trust is a type of trust that limits the trustee's discretion as to the purpose of the distributions. This type of trust typically contains language that distributions should supplement, but not supplant, sources of income including SSI or other governmental benefits.<sup>107</sup>

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<sup>102</sup> POMS §S.I. 01120.200 B 4.

<sup>103</sup> POMS §S.I. 01120.200 B 8.

<sup>104</sup> POMS §S.I. 01120.200 B 10.

<sup>105</sup> POMS §S.I. 01120.200 B.12.

<sup>106</sup> POMS §S.I. 01120.D(3).

<sup>107</sup> POMS §S.I. 01120.200 B 13.

### **2.2.8. Third Party Trust**

A Third Party Trust is a trust established by someone other than the beneficiary as grantor.<sup>108</sup> An Ohio court held that a non-self-settled trust in which the Medicaid recipient was beneficiary could not be considered in determining Medicaid eligibility. The trust was a Third Party Special Needs Trust established by the mother with the mother's own resources and a disabled child as beneficiary.<sup>109</sup>

### **2.2.9. Trusts Assets as Resources**

The POMS discusses trust assets as resources as follows” “If an individual (claimant, recipient, or deemor) has legal authority to revoke the trust and then use the funds to meet his food, clothing or shelter needs, or if the individual can direct the use of the trust principal for his/her support and maintenance under the terms of the trust, the trust principal is a resource for SSI purposes.”<sup>110</sup> Again, the test is clearly whether the beneficiary has a right to revoke the trust or compel distributions.

#### **2.2.9.1. Revocation**

In a third party special needs trust, revocation is not usually an issue, because the grantor and the beneficiary are different and a residual beneficiary is named to take the trust assets upon the death of the beneficiary. The beneficiary, therefore, has no authority to revoke the trust. In the self-settled trust the grantor and the beneficiary are the same and the trust contains a payback provision for Medicaid. Drafters do not always include a residual beneficiary and, therefore, revocation becomes an issue. The POMS state:

A beneficiary generally does not have the power to revoke a trust. However, the trust may be a resource of the beneficiary, in the rare instance, where he/she has the authority under the trust to direct the use of the trust principal. (The authority to control the trust principal may be either specific trust provisions allowing the beneficiary to act on his/her own or by ordering actions by the trustee.) In such a case, the beneficiary's equitable ownership in the trust principal and his/her ability to use it for support and maintenance means it is a resource.<sup>111</sup>

This would apply to a support trust where the beneficiary would have the right to compel distributions from the trust to or on behalf of the beneficiary.

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<sup>108</sup> POMS §S.I. 01120.200 B 17.

<sup>109</sup> *Carnahan v. Ohio Department of Human Services*, 139 Ohio App. 3d 214, 743 N.E. 2d 473 (2000), *EISP appeal to Supreme Court of Ohio denied*, 91 Ohio St. 3d 1448, 742 N.E. 2d 146 (2001).

<sup>110</sup> POMS §S.I. 01120.200.D.1.a.

<sup>111</sup> POMS §S.I. 01120.200.D.1.b.

### 2.2.9.2. Availability

The POMS recognize a two-pronged test for purposes of determining “availability.” If the beneficiary of the trust has no right to revoke the trust or to direct the use of trust assets for his or her own support and maintenance, the trust principal is not an available resource.<sup>112</sup>

The revocability of a trust and the ability to direct the use of the trust principal depends on the terms of the trust agreement and/or on state law. If a trust is irrevocable by its terms and under state law cannot be used by an individual for support and maintenance, it is not a resource. This provides the legal basis for a special needs trust.

### 2.2.10. Disbursements from Trust

A special needs trust must not only be properly drafted and funded, but it is crucial that it also be properly administered. Improper distributions from a properly drafted and funded trust can cause the loss of public benefits to the beneficiary of the trust.

**Example:** Jill is the trustee of a special needs trust established by her deceased mother, Paula, for the benefit of Paula's daughter, Anne. Anne's living expenses, including rent, food, transportation, and clothing, total approximately \$2,000 per month. Jill sends Anne a check on the first of every month for \$2,000 so that Anne can pay her expenses. Since Anne is receiving cash income in excess of her monthly SSI payment of \$552, she loses her SSI. Since Anne received Medicaid based on her SSI payment, she also loses Medicaid.

#### 2.2.10.1. Income

The POMS provide: “If the trust principal is not a resource, disbursements from the trust may be income to the SSI recipient beneficiary, depending on the nature of the disbursements.” Regular rules to determine when income is available apply.<sup>113</sup>

The POMS further provide: “Cash paid directly from the trust to an individual is unearned income.”<sup>114</sup> Therefore, it is crucial for the trustee of a special needs trust to have a clear understanding of the SSI income rules and to limit distributions to those expenditures that are appropriate.

**Example:** Jill, a disabled adult person, is receiving SSI. Joan is the trustee of a special needs trust established by Jill's parents for her benefit. Jill likes to read the *New York Times*. Joan arranges with the local newspaper distributor to deliver the *New York Times*

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<sup>112</sup> *Id.*

<sup>113</sup> POMS §S.I. 01120.200.E.1.

<sup>114</sup> POMS §S.I. 01120.200.E.1.a.

to Jill on a daily basis, including Sundays, and pays the bill directly to the newspaper distributor. This is not considered income to Jill.

### **2.2.10.2. In-Kind Support and Maintenance**

Disbursements that result in receipt of In-Kind Support and Maintenance (ISM) are defined as food, clothing, or shelter received as a result of disbursements from the trust by the trustee to a third party in the form of in-kind support and maintenance and are valued under the presumed maximum value (PMV) rule.<sup>115</sup> It is often appropriate to make ISM payments and for the beneficiary to have a reduction in benefits. Therefore, a trust document might contain language authorizing the trustee to make distributions for “food, clothing, and shelter” for the beneficiary. The SSI monthly payment may be inadequate to provide the appropriate level of food, clothing, and shelter for the beneficiary. As long as the SSI payment is maintained, although at a reduced level, Medicaid eligibility is maintained.

### **2.2.10.3. Third Party Non-Income Payments**

Since these distributions do not result in any reduction of SSI benefit, they are the most desirable types of distributions for a trustee to make. It is important that the distributions be made directly to the third party, not to the trust beneficiary. The POMS state: “Disbursements from the trust by the trustee to a third-party that result in the individual receiving items that are not food, clothing or shelter are not income. For example, if trust funds are paid to a provider of medical services for care rendered to the individual, the disbursements are not income for SSI purposes.”<sup>116</sup>

These rules are the basic rules for trust administration and define what distributions can be made from a trust and the impact of such distributions on the SSI benefit of the trust beneficiary. It is crucial that trustees are aware of these rules.

### **2.2.11. Assignment**

Some payments are assignable by law while others are not. Payments that are assignable may be assigned to special needs trusts.

#### **2.2.11.1. Non-assignable Payments**

Certain payments are non-assignable by law and, therefore, are income to the individual entitled to receive the payment under regular income rules. They may not be paid directly to a special needs trust. Non-assignable payments include:

- Temporary Assistance to Needy Families (TANF);
- Railroad Retirement Board–Administered Pensions;

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<sup>115</sup> POMS §S.I. 01120.200E.1.b.

<sup>116</sup> POMS §S.I. 01120.200.E.1.c.

- Veteran's pensions and assistance;
- Federal employee retirement payments (CSRS, FERS) administered by the Office of Personnel Management;
- Social Security title II and SSI payments; and
- Private pensions under the Employee Retirement Income Security Act (ERISA) (29 U.S.C.A. §1056(d)).<sup>117</sup>

These payments cannot be assigned to a trust and protected through the use of a special needs trust.

### **2.2.11.2. Assignable Payments**

An assignable payment is defined as:

A legally assignable payment (see above for what is not assignable), that is assigned to a trust, is income for SSI purposes unless the assignment is irrevocable. If the assignment is revocable, the payment is income to the individual legally entitled to receive it.<sup>118</sup>

Thus, it would appear that an irrevocable assignment of an alimony payment to a self-settled special needs trust would protect SSI benefits. For example, if a divorced woman is entitled to \$300 per month alimony, the receipt of the alimony would reduce her SSI payment by \$300 per month. However, if the \$300 is paid into a special needs trust, the SSI payment remains unchanged.

There is an issue as to whether worker's compensation benefits are assignable. The Social Security Administration will permit an assignment of worker's compensation to a Self-Settled Special Needs Trust, if state law permits the assignment of worker's compensation benefits. Only the items discussed in subsection [A] cannot be assigned under the POMS.

### **2.3. Three Major Issues Involved in a Special Needs Trust**

The three key issues in both types of Special Needs Trusts are: availability, transfer rules, and pay back requirements.

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<sup>117</sup> POMS §S.I. 01120.200.F.1.c.

<sup>118</sup> POMS §S.I. 01120.200.G.1.d.

## 2.3.1. Availability

### 2.3.1.1. Trustee's Discretion

Assets held in a properly-drafted special needs trust are not available to the disabled beneficiary. If the assets in the trust are available, the beneficiary loses public benefits. If the assets are unavailable, they are not considered in determining public benefits eligibility.

The key as to whether or not the trust assets will be held to be available is the *discretion* of the trustee. Under the POMS trust assets are available if the individual has the legal authority to direct a distribution from the trust for his or her support and maintenance or has the right to revoke the trust.<sup>119</sup> Therefore, assets held in a discretionary trust are not available. The POMS defines a discretionary trust as “a trust in which the trustee has full discretion as to the time, purpose and amount of all distributions. The trustee may pay to or for the benefit of the beneficiary all or none of the trust as he or she considers appropriate. The beneficiary has no control over the trust.”<sup>120</sup> Therefore, the discretion of the trustee determines availability of trust assets.

Central to the issue of availability is the *distribution standard* used in the trust document.<sup>121</sup> If the distribution standard is too broad, the trust may be considered an available resource in some states. If the distribution standard is too narrow, the trustee is restricted from making distributions for the maximum benefit of the beneficiary. There are six types of distribution standards:

- *Support Trusts* - These are treated as available resources.<sup>122</sup>
- *Fully Discretionary Trusts* - These may or may not be available depending on state law.<sup>123</sup>
- *Discretionary Support Trusts* - These may or may not be available depending on state law.
- *Distributions for ISM* - Distributions for food, clothing and shelter are considered distributions for in-kind support and maintenance (ISM). These distributions will reduce but not eliminate public benefits. As a practical matter, housing is often difficult to obtain without a distribution

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<sup>119</sup> POMS § SI 01120.200D 1 (a).

<sup>120</sup> POMS § SI 01120.200B.10.

<sup>121</sup> Cynthia Barrett, “Distribution Standard for the Special and Supplemental Needs Trust,” NAELA Quarterly (Summer 2001).

<sup>122</sup> *Lange v. Commonwealth of Pa. Dept. of Public Welfare*, 515 Pa. 428, 528 A.2d 1335 (1987); *Snyder v. Commonwealth of Pa. Dept. of Public Welfare*, 528 Pa. 491, 598 A.2d 1283 (1991); *Commonwealth Bank and Trust Company v. Commonwealth of Pa. Dept. of Public Welfare*, 528 Pa. 482, 598 A.2d 1279 (1991); *Rosenberg v. Commonwealth of Pa. Dept. of Public Welfare*, 545 Pa. 27, 689 A.2d 767 (1996); *Shaak v. Pa. Dept. of Public Welfare* (Pa. Sup. Ct., No. 0032MD Appeal Docket 1999 (3/27/00)).

<sup>123</sup> *Ohio Rev. Code § 1339.51(D)(4)*; *In Re Will of Cooper*, 76 Misc. 2d 166, 349 N.Y.S.2d 613 (Surr. Ct., 1973); *Zeoli v. Comm’r of Social Servs.*, 179 Conn. 83, 425 A.2d 553 (1979).

from the special needs trust. In Minnesota, a distribution from a trust that “reduces” public benefits is prohibited.<sup>124</sup>

- *Precatory Language* - Some practitioners use a fully discretionary standard of distribution with precatory language urging the trustee to exercise discretion to make distributions on behalf of the beneficiary for supplemental needs. State law must be consulted, particularly in Ohio.<sup>125</sup>
- *Spigot Trusts* - The last distribution standard is a spigot trust. A spigot distribution standard is fully discretionary, but expressly give the trustee authority to reduce public benefits. Such a standard is explicitly authorized in New York.<sup>126</sup> Such trusts are also recognized in New York and New Jersey in the regional POMS.<sup>127</sup>

### **2.3.1.2. Periodic Payments**

If the beneficiary has a right to mandatory periodic payments from the trust, the trust assets may be a resource to the individual. The value would be the present value of the anticipated string of payments unless a spend-thrift clause or other language prohibits the anticipation of such payments.

### **2.3.1.3. Crummey Powers**

Crummey powers present a special problem with respect to a special needs trust because, as a general rule, the Crummey provision is a non-cumulative withdrawal right to the beneficiary. The rule is that if the gift is subject to withdrawal by the beneficiary in the same month that it is made to the trust, the gift is income for SSI purposes. If the withdrawal rights do not begin until the following month, the gift is not income in the month it is made. However, if the withdrawal rights begin after the first day of the following month and the funds are subsequently withdrawn, the funds are unearned income in the month the withdrawal rights are exercised. If the gift is subject to withdrawal as of the first moment of any month, the funds are a resource to the individual in that month. If the withdrawal rights do not begin until after the first of the month, the funds are not resources for that month unless withdrawn in which event they are considered income. The solution is to make a gift to the trust at the end of month 1 and make the power of withdrawal effective on the second day of month 2 and terminate on the last day of the month. The gift will not be income to the beneficiary in month 1 or a resource to the individual in month 2, unless the beneficiary actually exercises the right of withdrawal.

## **2.3.2. SSI/Medicaid Transfer Rules**

The second key in drafting trusts is whether or not the funding of the trust constitutes a transfer subject to the transfer penalty rules of SSI and/or Medicaid.

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<sup>124</sup> Minn. Stat. 501B.89, 2(d).

<sup>125</sup> *Id.*

<sup>126</sup> N.Y. EPTL 7.1.12(e)(2)(i)(5).

<sup>127</sup> POMS SI NY 01120.200(A)(4).

### **2.3.2.1. Third Party Special Needs Trust**

- *Revocable.* If the third party special needs trust is an inter vivos revocable trust, then the assets are still available to the grantor so no transfer has taken place. A transfer will be considered to have taken place on the date of the payment from the trust to the beneficiary.
- *Irrevocable Inter Vivos Trust.* If a transfer is made to an irrevocable inter vivos third party special needs trust during the lifetime of the grantor, the transfer is subject to the SSI and Medicaid transfer rules.
- *Irrevocable Testamentary Third Party Special Needs Trust.* A trust is defined as including any legal instrument or device that is similar to a trust, but not including testamentary trusts.<sup>128</sup> Therefore, testamentary transfers to a third party special needs trust are not subject to SSI or Medicaid transfer rules. There are no transfer penalties for a transfer to a self-settled special needs trust, because such transfers are exempt.<sup>129</sup>

### **2.3.2.2. Self-Settled Special Needs Trust**

There is no transfer penalty for transfer to a self-settled special needs trust, because such transfers are exempt by statute.<sup>130</sup>

### **2.3.2.3. Section 8 Housing**

An issue arises as to the effect of a special needs trust on Section 8 Housing benefits. To the extent that the disabled individual establishes a self-settled special needs trust with proceeds of a tort settlement, inheritance, or any other lump sum, then HUD considers the transfer as a transfer for less than fair market value and counts the trust assets as resources for two years. The significance is that income at a passbook savings rate is imputed for two years from the date of the funding of the trust.

If income or principal is regularly distributed from either a payback trust or a third party trust, it is counted as income. Recurring distributions from an SNT for the benefit of a Section 8 tenant are specifically included in income, unless it is specifically excluded. Generally, the excluded distributions are those that are temporary, nonrecurring or sporadic, including gifts.

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<sup>128</sup> 42 U.S.C. §1396p(d)(6); HCFA Transmittal 64 §3259.1A1.

<sup>129</sup> 42 U.S.C. §1396p(d)(4)(A).

<sup>130</sup> 42 U.S.C. § 1396p(d)(4)(A).

### 2.3.3. Payback

The Medicaid payback provisions are a creature of statute. They were established in OBRA '93. They apply only to Miller Trusts,<sup>131</sup> Pooled Trusts,<sup>132</sup> and Under 65 Disability Trusts or self-settled special needs trusts.<sup>133</sup> The Health Care Financing Administration (HCFA) has clarified and confirmed this interpretation in a letter dated January 19, 2001, to Raymon B. Harvey.<sup>134</sup>

There is no payback requirement to the state Medicaid agency from third party special needs trusts. Those trusts may provide that upon the death of the disabled beneficiary assets are distributed to remaindermen. In a self-settled special needs trust a payback provisions is required by statute.

There appears to be no restriction in federal law on naming a family member as contingent beneficiary of the guaranteed portion or a structure upon the death of the primary beneficiary of a structure, however, state law must be consulted. The Supreme Court of New York held that there is no authority to consider any guaranteed payment remaining after the death of the trust beneficiary from the trust assets subject to the State's remainder interest.<sup>135</sup> This would have the effect of avoiding a payback to Medicaid since the structure would then be paid to the family member and not to the trust. Only assets remaining in the trust would be required to be paid to Medicaid. The guaranteed portion of the future payment would be includable in the estate of the deceased beneficiary. Consideration should be given to purchasing a commutation rider form the insurance company to provide for funds to pay the federal estate tax.

Prior to a distribution to residual beneficiaries Medicaid must be repaid for all funds expended on behalf of the deceased Medicaid recipient. If more than one state has made payments and the funds remaining in the trust are insufficient to repay all of the states, then payment is made on a pro rata basis.

A California case carved out an exception to the payback provisions where the sole beneficiary of the trust on the death of the primary beneficiary is a disabled child.<sup>136</sup> In the Arnold case a self-settled special needs trust was established for the benefit of Etoria Hatcher. It was funded with \$450,000 from the proceeds of a settlement of a lawsuit. The trust provided that upon death the remaining principal and income was to be distributed to Brenda Arnold, the daughter of Etoria Hatcher. Brenda Arnold was disabled. The court held that Congress intended that there be an interplay between the estate recovery rules and the payback provisions in self-settled special needs trusts. The court held that the provisions of 42 U.S.C. §1396p(d)(4)(A) apply only to Medicaid eligibility and that federal estate recovery law expressly excludes assets distributed to an adult disabled child.

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<sup>131</sup> 42 U.S.C. §1396p(d)(4)(B).

<sup>132</sup> 42 U.S.C. §1396p(d)(4)(C).

<sup>133</sup> 42 U.S.C. §1396p(d)(4)(A).

<sup>134</sup> Thomas D. Begley, Jr. & Jo-Anne Herina Jeffreys, Representing the Elderly Client, Law & Practice, Aspen Publishers Inc., Appendix 8A.

<sup>135</sup> IMO Eddie Sanango, Supreme Court of New York, County of Kings, Index No. 41383/94 (Oct. 22, 2002).

<sup>136</sup> Bonta v. Arnold, 2004 W.L. 2952765 (Cal. App. 2 Dist.) (Dec. 22, 2004).

## **2.4. Third Party Special Needs Trusts**

### **2.4.1. Estate Planning Options**

Parents of disabled children have four options with respect to estate planning: (1) disinherit the disabled child; (2) distribute the assets to the disabled child; (3) distribute assets to siblings with the understanding that the siblings will use the assets for the benefit of the disabled child; or (4) distribute assets to a special needs trust.

#### **2.4.1.1. Disinherit Disabled Child**

The first estate planning option is to simply disinherit the child. If the parent's estate is relatively modest and the child's needs are great, this may be the best approach, because any legacy from a modest estate would be inadequate to meet significant needs of a child.

#### **2.4.1.2. Gift to Disabled Child**

The second option is to make the gift to the disabled child. The problem with distribution assets to the disabled child is the impact it has on government benefits that are means tested. Benefits may be reduced or eliminated. This may render the disabled child ineligible for SSI, Medicaid, or federally assisted housing, as well as for supported employment and vocational rehabilitation services, group housing, job coaches, personal attendant care, and transportation assistance. In addition, the child may be charged for program benefits previously received. While the monthly payment received from SSI is often important, Medicaid is crucial since it represents the child's medical insurance. For example, patients in public mental institutions are charged for their care. If a child inherits a substantial sum of money, the state will charge the resident for the cost of care, and will continue to charge until all of the monies have been exhausted. The state may even back-charge for care previously provided. The care will, usually, be the same whether paid for privately or by government programs. Use of a properly drafted trust avoids virtual confiscation of the funds by public institutions.

#### **2.4.1.3. Distribution to Sibling**

The third option is to distribute the assets to a sibling with the understanding that the sibling will use the monies for the benefit of the disabled child. Distribution to other children is a risky proposition. If assets are distributed to siblings, the asset are held in the name of the sibling. They are then exposed to creditors of the sibling. The assets may also be claimed in a divorce action by the sibling's spouse. In addition, there is also the risk of misappropriation or mismanagement by the sibling. Also, if the sibling spends more than \$11,000 per year of the inheritance for the benefit of the disabled person, a taxable gift may result.

#### **2.4.1.4. Special Needs Trust**

The final option is distribution to a special needs trust. The primary purpose of the special needs trust is to benefit individuals who qualify for public assistance programs that are

means-tested. In addition, since the disabled child is often unable to manage his or her financial affairs, by establishing a special needs trust the parent ensures proper management by a qualified trustee. A special needs trust is designed so that the funds are not considered “available” to the beneficiary. A special needs trust must be a discretionary spendthrift trust that limits the discretion of the trustee. No distribution of principal and/or income may be made that would reduce the amount of public benefits to which the beneficiary would otherwise be entitled. The beneficiary cannot compel distribution.

#### **2.4.2. Testamentary or Inter Vivos**

As a general rule, it is preferable to have the special needs trust established as an inter vivos trust. The advantage of an inter vivos trust is that if other family members want to provide for the disabled person, they may do so through the already existing special needs trust. Another advantage is that if an individual is to serve as successor trustee, that individual can gain some experience acting as a co-trustee during the grantor's lifetime. This experience is gained under the watchful eye and direction of the grantor and will be valuable to the successor trustee on the death of the grantor. An inter vivos trust can be a standby trust that remains unfunded until the death of the grantor, if that is what the grantor intends. The will of the grantor simply would pour all or a part of the grantor's assets into the trust.

#### **2.4.3. Revocable or Irrevocable**

Whether an inter vivos special needs trust is revocable or irrevocable is often determined by the tax objectives of the settlor. If the grantor wants to maintain maximum control over trust assets and is not concerned about federal estate and gift taxes, the trust can be revocable until the death of the grantor or until it is funded by assets gifted by a third party such as a grandparent or aunt or uncle. Keeping the special needs trust revocable allows grandparents to make gifts into the special needs trust that qualify for the gift tax annual exclusion as gifts to the grantor without need for Crummey provisions in the trust instrument.<sup>137</sup> It also obviates the need to file fiduciary income tax returns, so long as the trust is revocable. If the grantor intends to utilize the trust to save estate or gift taxes, he might establish the trust as irrevocable from the outset.

#### **2.4.4. Tax Considerations**

In drafting a third party special needs trust, practitioners need to consider the income, gift, and estate tax consequences to the parties involved. The trust should be designed to achieve the tax objectives of the parties.

##### **2.4.4.1. Income Tax**

A trust can be designed so that income is taxed to grantor, the beneficiary, or the trust. Since trust tax rates are compressed as compared to the tax rates for individuals, it is usually undesirable to have the income taxed to the trust. For example, in 2005 the maximum federal

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<sup>137</sup> Crummey provisions give the trust beneficiary the right to withdraw money from the trust. The gift made in trust then qualifies as “present interest” qualifying for the annual gift exclusion. *Crummey v. Commissioner*, 397 F.2d 82 (9<sup>th</sup> Cir. 1968); Rev. Rul. 80-261, 1980 C.B. 79.

income tax bracket of 35% is reached at \$9,750<sup>138</sup> of income for a trust as compared with \$326,450<sup>139</sup> of income for a married couple filing jointly.<sup>140</sup>

Generally, a trust can be a simple trust or a complex trust. In a simple trust, the income is paid out to the beneficiary and the beneficiary is taxed on the income. However, by the very nature of a special needs trust, income cannot be required to be paid to the beneficiary. Therefore, the special needs trust generally cannot be a simple trust because the trust cannot mandate that income be distributed to the beneficiary. Thus, a special needs trust is a complex trust. For a trust to be a complex trust, it must be irrevocable.<sup>141</sup> To the extent that income is paid to or for the benefit of the beneficiary, the trustee would furnish the beneficiary with a schedule K-1 of Form 1041 and the income tax would be payable by the beneficiary.<sup>142</sup> To the extent that income is retained by the trust, it would be taxable to the trust.<sup>143</sup>

If it is desirable that trust income be taxed to the grantor, a grantor trust can be crafted.<sup>144</sup> A special needs trust is a grantor trust if it is revocable. Since most funded special needs trusts are irrevocable, in order to convert an irrevocable special needs trust into a grantor trust, the trust can give the grantor a right to reacquire trust corpus by substituting other property of equivalent value.<sup>145</sup> The power of substitution causes the trust to be a grantor trust for income tax purposes, but does not cause the trust assets to be included in the grantor's taxable estate. All income from a grantor trust is taxable to the grantor, even if distributed to the beneficiary. However, such distributions are gifts to the beneficiary for gift tax purposes, unless contributions into the trust are completed gifts for tax purposes.

A third party special needs trust is almost never a grantor trust. This type of trust is ordinarily a separate taxpayer with its own taxpayer identification number and the trust files annual federal and state fiduciary income tax returns. To the extent distributions have been made, a K-1 is delivered to the beneficiary. The beneficiary then reports the income on the beneficiary's own federal and state income tax returns, if applicable.

#### **2.4.4.2. Gift Tax**

The gift tax treatment of contributions to and distributions from a special needs trust depend on whether the trust is revocable or irrevocable. If it is revocable, contributions by the grantor to the trust have no gift tax consequences as the grantor retains the right to reacquire the assets. Contributions by third parties are taxable unless sheltered by the gift tax annual exclusion.<sup>146</sup> Distributions from a revocable special needs trust are taxable gifts by the grantor unless sheltered by the gift tax annual exclusion.

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<sup>138</sup> Rev. Proc. 2004.71 Section 3.01 Tables 5 and 1.

<sup>139</sup> *Id.*

<sup>140</sup> I.R.C. §1(e)

<sup>141</sup> I.R.C. §642(b)

<sup>142</sup> I.R.C. §1(a)

<sup>143</sup> I.R.C. §1(e)

<sup>144</sup> I.R.C. §§673-677

<sup>145</sup> I.R.C. §675(4)(C)

<sup>146</sup> I.R.C. §2503(b)

A contribution to an irrevocable special needs trust is, usually, a taxable gift by the grantor, unless the grantor retains a power of appointment or other right to determine who receives trust distributions.<sup>147</sup> The trust can be drafted with Crummey powers so that annual exclusion gifts can be made to the trust.<sup>148</sup> Existence of the Crummey power makes the contribution a gift of a “present interest,” enabling the grantor to utilize the gift tax annual exclusion. However, the holder of the Crummey power should not be the disabled person; otherwise, the contribution would be an “available” resource. The Crummey power must be given to another beneficiary of the trust. If the grantor is a trustee, the contribution to the special needs trust is not a completed gift, because the trustee determines whether the disabled or remainder beneficiary benefits from the distributions.

#### **2.4.4.3. Estate Taxes**

A special needs trust should be drafted in a fashion that will achieve the estate tax objectives of the grantor. If estate taxes are not a consideration, a revocable trust can be used until such time as the grantor dies or the trust is funded with the assets of a third party. If the grantor does not have a taxable estate, the special needs trust can be designed to reduce the estate tax burden. The special needs trust may be substantially funded with investments or life insurance during the lifetime of the grantor. However, the grantor cannot serve as trustee if estate tax savings are desired.<sup>149</sup> The special needs trust can be an irrevocable life insurance trust funded with life insurance paid for by contributions from the grantor with appropriate Crummey powers. Again, a beneficiary other than the disabled person should be the holder of the Crummey power. To be outside of the grantor's estate, the assets of the trust must be considered taxable gifts at the time the trust was funded. The way to fund the trust is with life insurance and appropriate Crummey powers or simply annual exclusion gifts. One method would be to fund the trust with assets that are likely to appreciate in value and use some of the grantor's unified credit.

### **2.5. Self-Settled Special Needs Trusts**

#### **2.5.1. Introduction**

When an injured party receives money as a result of a tort action, the settlement or award may jeopardize his or her public benefits. The same result may occur if a disabled person receives an equitable distribution in settlement of a matrimonial action or if a disabled person receives an inheritance. Alimony payments are assignable income and should be able to be paid into a special needs trust to preserve eligibility for public benefits. Similarly, receipt of proceeds of a settlement may cause a person to lose his or her public benefits. In 1993 as part of the Omnibus Budget Reconciliation Act of 1993 (OBRA-93) Congress created a safe harbor for the use of special needs trusts in these situations.<sup>150</sup> These trusts are commonly referred to as (d)(4)(A) trusts. While this chapter will focus on the use of such trusts in a tort claim setting,

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<sup>147</sup> Treas. Reg. §25.2511-2(c); Ltr. Rul. 9437034

<sup>148</sup> *Crummey v. Commissioner*, 397 F.2d 82 (9<sup>th</sup> Cir. 1968). A Crummey power gives the beneficiary a right to withdraw the contribution into the trust. The right of withdrawal is limited for a period of time (i.e., 30 days)

<sup>149</sup> I.R.C. §§2036, 2037

<sup>150</sup> 42 U.S.C. §1396p(d)(4)(A)

they can be used in any situation in which the settlor is establishing a trust with his or her own funds. Types of situations in which self-settled special needs trusts are used include:

- Tort recovery
- Inheritance
- Equitable distribution
- Alimony

Recently enacted provisions of the Foster Care Independence Act of 1999<sup>151</sup> apply to self-settled special needs trusts. They do not apply to third-party special needs trusts. If the assets of the individual are used to establish the trust, it is considered a self-settled trust.<sup>152</sup>

If the trust is revocable, it is considered an available resource.<sup>153</sup> If the trust is irrevocable, it is considered an available resource to the extent that payments from the trust could be made to or for the benefit of the grantor or the grantor's spouse.<sup>154</sup> However, these provisions do not apply to (d)(4)(A) trusts.<sup>155</sup>

### 2.5.2. Statutory Drafting Issues

The most common reason for SSA to reject a self-settled special needs trust is the application of the “Doctrine of Worthier Title.” Under the *Doctrine of Worthier Title* if a trust does not specifically name a residual beneficiary, the trust is revocable. If the trust is revocable, the assets in the trust would be considered available to the beneficiary. Social Security has determined that a state is not a residual beneficiary as a result of the payback provision, but is a mere creditor. It has only a right to reimbursement for payments made, it does not have a right to more than its payments nor the trust residue.

A trust that names “heirs at law or next of kin” is held not to name a specific remainder beneficiary and, therefore, the trust would have only one beneficiary, the lifetime beneficiary, and that beneficiary would have the right to revoke the trust. Therefore, the trust would be irrevocable. Whether or not the *Doctrine of Worthier Title* applies is a matter of state law. State law differs significantly on this issue. The Social Security regional offices apply state law. Five SSA regional offices have issued regional POMS on the issue. They are: Atlanta, Boston, Chicago, Dallas, and New York. Regional POMS spell out the application of *Doctrine of Worthier Title* to the states within their respective regions.

In an unpublished case, a Vermont Court held that a self-settled special needs trust established in West Virginia was revocable despite its expressed statement that it is irrevocable because the trust names the grantor's “heirs” as the remainder beneficiaries. Don Thompson, who established the trust, subsequently moved from West Virginia to Vermont. The U.S. District Court for Vermont held that the trust was revocable although West Virginia had

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<sup>151</sup> H.R. 3443 Foster Care Independence Act of 1999 §205.

<sup>152</sup> *Id.* at §205(e)(2)(A).

<sup>153</sup> *Id.* at §205(e)(3)(A).

<sup>154</sup> *Id.* at §205(e)(3)(B).

<sup>155</sup> 42 U.S.C. §1396(p)(d)(4)(A).

extinguished the *Doctrine of Worthier Title* as a rule of law. The court held that West Virginia retained the *Doctrine of Worthier Title* as a rule of construction creating a presumption that when making a disposition to his “heirs” a grantor intends to create a reversionary interest in himself.<sup>156</sup>

In an unpublished case the U.S. Court of Appeals for the 11<sup>th</sup> Circuit reached a similar result.<sup>157</sup> Tiffany Sniarowski received \$560,068.90 in settlement of a medical malpractice claim. She established a trust labeled “Irrevocable Medicaid Disability Trust.” The trust stated that it was irrevocable. The trust contained payback provision to the State of Florida for the actual value of Medicaid benefits Tiffany will have received and the remainder to anyone appointed by Tiffany in her will or to whomever is entitled to inherit under the laws of intestacy if no will exists. The court held that under Florida law Tiffany was the sole beneficiary and could compel the termination of the trust. This was true notwithstanding the fact that Tiffany was a minor. The court held that a guardian could have obtained approval of a court to terminate the trust. The court held that under Florida law her intestate heirs had no vested interest in the trust assets.

Andy Hook, an elder law attorney in Portsmouth, Virginia, suggests that the trust contain a statement of intent that the *Doctrine of Worthier Title* not apply to the construction of the trust or that the trust contain a \$10 vested interest in a named beneficiary. For example, if a parent established a trust with a contribution of \$10 and the trust provided that upon the beneficiary's death the parent be named beneficiary of the trust to the extent of \$10, this may solve the problem. The difficulty is that a statement of intent may not be held binding in cases where the beneficiary is considered the grantor and the beneficiary is a minor or disabled.

### 2.5.2.1. The Problem

Tort victims very often face the prospect of enormous medical bills for the rest of their lives. If they receive a settlement unprotected by an appropriate trust, the settlement monies will quickly be exhausted through payment of medical bills. As with a third party special needs trust, the goal of a self-settled special needs trust is to maintain the disabled person's public benefits, including Medicaid, so that Medicaid will pay the medical bills and use the settlement proceeds to enrich the quality of life of the disabled person.

Very often, injured parties are already receiving public benefits such as SSI. Therefore, the special needs trusts must be drafted to satisfy the POMS.<sup>158</sup> They must also be drafted to comply with the requirements of OBRA-93.<sup>159</sup> For many tort victims, Medicaid is the only form of medical insurance that they will ever be able to obtain. The question, therefore, is “how can the tort victim enjoy the benefits of the recovery while at the same time not losing vital public benefits?”

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<sup>156</sup> Thompson v. Barnhart (D. Vt. No. 2-02-CV-141, July 17, 2003).

<sup>157</sup> Sniarowski v. Barnhart (DC Dkt. No. 01-141-67-CV-NCR, Nov. 14, 2002).

<sup>158</sup> See discussion of the POMS at §12.03 *supra*.

<sup>159</sup> 42 U.S.C. §1396p(d)(4)(A)

Persons receiving an inheritance, alimony, or child support payments will also be disqualified from means-based public benefits. The solution is to place those payments in a self-settled special needs trust.

### **2.5.2.2. The Solution–Self-Settled Special Needs Trust**

The solution to this problem is the use of a special needs trust authorized under OBRA-93.<sup>160</sup> These trusts are commonly referred to as (d)(4)(A) trusts or payback trusts. These trusts are extremely complex and involve sophisticated issues relating to both public benefits and tax law. A poorly drafted trust may expose the beneficiary and others to unnecessary taxation or disqualify them from public benefits. For this reason, personal injury attorneys often work with specialists from the field of elder law or estate planning who are familiar with all of the ramifications of these documents and the complexities of public benefits law and taxation.

Special needs trusts are authorized at 42 U.S.C. §1396p(d)(4)(A).

*“A trust containing the assets of an individual under age 65 who is disabled (as defined in § 1614(a)(3)) and which is established for the benefit of such individual by a parent, grandparent, legal guardian of the individual, or a court, if the state will receive all amounts remaining in the trust upon the death of such individual up to the amount equal to the total medical assistance paid on behalf of the individual under a state plan under this title.”*

There are several issues pertaining to the statutory language authorizing the special needs trust that must be considered.

#### **2.5.2.2.1. Assets of the individual**

The Trust must be funded with *assets of the individual*. Even if the document names a different grantor, if the assets directed to the trust are those of the beneficiary, it is a self-settled special needs trust.<sup>161</sup> Assets recovered in a tort action are considered to be assets of the individual. In some states, such as Arizona, this is interpreted to mean that the trust must be funded *exclusively* with assets of the individual rather than assets of the parent or grandparent as well as assets of the individual. Assets that the beneficiary received through inheritance or equitable distribution are also considered assets of the individual for this purpose. Technically alimony and child support are income and not assets, but it is likely that they would be considered assets of the individual for purposes of establishing a self-settled special needs trust.

For purposes of determining Veterans pension benefits, the assets in a self-settled special needs trust must be considered in determining eligibility for a VA pension.<sup>162</sup>

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<sup>160</sup> *Id.*

<sup>161</sup> POMS SI 01120.200.B.7

<sup>162</sup> Department of Veterans Affairs, Office of the General Counsel, Washington, D.C., VAO Pg. Cp. Rec. 33-97.

#### 2.5.2.2.2. Under 65 years of age

A so-called (d)(4)(A) trust (i.e., a self-settled special needs trust) can be established only for a person *under 65 years of age*. This means that the trust document must be in place and funded prior to the beneficiary's attaining his or her 65th birthday. The Centers for Medicare & Medicaid Services ("CMS") has indicated that the trust can continue after the beneficiary attains the age of 65.<sup>163</sup> However, additions to the trust cannot be made after the beneficiary reaches age 65. In the case of a structured settlement annuity in place prior to the beneficiary's attaining age 65, payment can continue to be made from the structure to the trust after the beneficiary reaches age 65. The Social Security Administration considers the structure itself to be "old money" and permits old money to earn "new money."

Persons over age 65 may avail themselves of the use of a pooled trust established by a non-profit association.<sup>164</sup>

#### 2.5.2.2.3. Disabled

The beneficiary of the trust must be *disabled* as defined in the Social Security Act.<sup>165</sup> The definition of disability for (d)(4)(A) trusts is the same definition contained in the Social Security Act, which is applied for determining eligibility for SSI or SSD. The Social Security Act provides "an individual shall be considered to be disabled for purposes of this subchapter if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than twelve months (or, in the case of a child under the age of 18, if he suffers from any medically determinable physical or mental impairment of comparable severity.)"<sup>166</sup>

Lawyers are frequently called upon to draft a special needs trust before the beneficiary has been determined to be disabled by the Social Security Administration. David Lillesand, an elder law/disability law attorney in Florida, suggests that lawyers obtain an advisory opinion or opinion letter from an experienced Social Security disability attorney as the foundation to proceed in drafting the special needs trust when the SSA disability determination has not yet been made.<sup>167</sup> The Program Operations Manual System ("POMS") provides that if there has not been a determination of disability, the case can be sent for a medical determination after the trust has been established.<sup>168</sup>

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<sup>163</sup> Letter from Sally K. Richardson, Director of the Medicaid Bureau of the Health Care Financing Administration, to James C. Corman, dated November 23, 1993.

<sup>164</sup> 42 U.S.C. § 1396p(d)(4)(C).

<sup>165</sup> 42 U.S.C. § 1382c(a)3A

<sup>166</sup> 42 U.S.C. § 1382c(a)3A

<sup>167</sup> SSI Analysis of Special Needs Trusts Using the POMS, by David J. Lillesand, Esq., Special Needs Trusts IV, Stetson University, Oct. 18, 2002.

<sup>168</sup> POMS SI 01150.121

#### **2.5.2.2.4. For the benefit of such individual**

The Trust must be established *for the benefit of such individual*. In some states, such as New Jersey, this has been interpreted to mean that the trust must be for the “sole benefit of” the disabled person.<sup>169</sup> In New York, special needs trusts must be for the “primary benefit of” the disabled individual.<sup>170</sup> The trust may provide for payment of reasonable compensation for trustees to manage the trust, as well as “reasonable costs associated with investment, legal or other services rendered on behalf of the individual.” Such payments do not violate the “sole benefit of” requirements.

The concept of “sole benefit of” leads to the concept of “*pro rata share*.” If the assets of a self-settled special needs trust need to be used for the sole benefit of the beneficiary, those persons receiving incidental benefits must contribute their pro rata share. For example, if there is a family of four consisting of two parents, one healthy child and one disabled child and the trust purchases a home, then the parents and healthy child must pay their pro rata share of all expenses relating to the home. Otherwise, the use of trust funds would not have been for the “sole benefit of” the disabled person.

A related issue is whether trust distributions can be made to discharge a “*legal obligation of support*” of a parent. Many states, such as New Jersey, by regulation prohibit the use of trust funds to discharge a legal obligation of support unless the parents are unable to satisfy the legal obligation of support from their own funds.

#### **2.5.2.2.5. Established by**

The Trust can be *established* only by a parent, grandparent, legal guardian of the individual, or a court.

##### **2.5.2.2.5.1. Parent or grandparent**

An issue has arisen as to whether a *parent* or *grandparent* is authorized to establish a trust since the monies used to fund the trust belong to the beneficiary. In some parts of the country, the Social Security Administration recognizes the authority of a parent or grandparent to establish an empty trust or a seed trust for the purpose of receiving a competent adult SSI beneficiary’s assets at a later time.<sup>171</sup>

Unfortunately, this leaves an issue in other states and also an issue when the beneficiary is a minor or an incompetent adult. There are two solutions to this problem. If the beneficiary is a competent adult, he can execute a power of attorney authorizing the parent or grandparent to establish the Trust. If the beneficiary is not a competent adult, then Andy Hook’s \$10 solution

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<sup>169</sup> N.J.A.C. 10:71-4.11(g)

<sup>170</sup> New York State Department of Social Services, Transmittal 96 ADM-8 IV A 7 b ii

<sup>171</sup> Regional Counsel’s Opinion Letter, Region III, dated August 27, 2003. Region III includes Delaware, the District of Columbia, Virginia, Maryland, Pennsylvania and West Virginia.

must be used.<sup>172</sup> Under this solution, the parent or grandparent establishes the trust and deposits \$10 of the parent's or grandparent's funds into the trust. State law must be consulted to determine if the funds of a third party may be deposited in a self-settled special needs trust. The parent or grandparent then has authority because that person is using his or her own money to establish the trust.

Whether or not a parent or grandparent can establish a seed trust is a matter of state law and also a potential issue with respect to the regional POMS. The POMS for Region III<sup>173</sup> concluded that where a parent or grandparent establishes an empty trust or seed trust for purposes of receiving a competent SSI beneficiary's assets at a later date, the trust will be recognized as valid in all states in Region III. These states include: Virginia, Delaware, Maryland, Pennsylvania, and West Virginia.

#### **2.5.2.2.5.2. Guardian**

A *guardian* can obtain a court order authorizing the guardian to establish the trust.<sup>174</sup> If the trust is established by the parent of a minor child, no power of attorney or other legal authority is required, because the parent is the natural guardian of the child.

As to the issue of whether a guardian can establish a self-settled special needs trust on behalf of the ward, a Wisconsin Appellate Court has ruled that the Wisconsin guardianship statute permits the transfer of guardianship assets to a d4A trust or Medicaid payback trust for the benefit of the Ward.<sup>175</sup>

A court can also refuse to establish a self-settled special needs trust if it is held that the trust would not be appropriate. In this case the trial court held that there were procedural and drafting problems pertaining to the trust and declined to establish the trust. The state appellate court upheld the decision of the trial court.<sup>176</sup>

#### **2.5.2.2.5.3. Court**

Having the trust established by the *court* does not necessarily mean the court must sign the document. In fact, many judges are reluctant to do so. The trust can be drafted and refer to the establishment of the trust by court order incorporating the trust by reference. The Social Security Administration will recognize trusts established in this manner.

If a disabled person is a minor or mentally incompetent, court supervision of a settlement is usually required. In cases where counsel wants a court to establish a trust but court supervision is not required, a complaint can be filed and the settlement put on the record so the parties can reach a compromise.

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<sup>172</sup> See Hook and Begley, Jr., "Elder Law: When is an Irrevocable Special Needs Trust Considered to be Revocable?," 31 ETPL 205 (Apr. 2004).

<sup>173</sup> PS 01825.009 Delaware, Aug. 27, 2003

<sup>174</sup> In the Matter of the Guardianship of Scott G.G., No. 02-1121 (Wis. App. Feb. 2, 2003)

<sup>175</sup> *Id.*

<sup>176</sup> Mental Hygiene Legal Services *Exrel.* Thomas C. v. Bishop, 748 NYS 2.d 617, 298 A.D. 2d 644 (App. Div. 2002).

#### **2.5.2.2.6. Payback**

The Trust must contain a *payback* provision providing that the State Medicaid Agency will receive all amounts remaining in the Trust upon the death of the beneficiary up to an amount equal to the total medical assistance paid. The Trust must contain specific language to that effect.<sup>177</sup> Reimbursement must be up to an amount equal to the total medical assistance paid on behalf of the individual. If more than one state paid for medical assistance for the beneficiary then all states must be reimbursed, and if the funds remaining in the trust are insufficient, the reimbursement is *pro rata* among the states.

The trust could contain the following expenses that can be deducted prior to pay back to the State Medicaid Agency:<sup>178</sup>

- Taxes due from the trust to the state or federal government because of the death of the beneficiary
- Reasonable fees for administration of the trust estate, such as an accounting of the trust of a court, completion and filing of documents, or other required actions associated with termination and wrapping up of the trust.

Payment of the following expenses are not permitted prior to reimbursement of the State Medicaid Agency:

- Payment of debts owed to third parties
- Funeral expenses
- Payments to residual beneficiaries

David Lillesand, an SSI and elder law attorney in Miami, Florida, has labeled the prohibition against trust payment of funeral expenses as the “stinking dead body rule.”

### **2.5.3. Non-Statutory Drafting Issues**

#### **2.5.3.1. Revocability**

Not only must the practitioner comply with Medicaid law, but the Social Security POMS must also be considered when drafting a special needs trust.<sup>179</sup> The main consideration when drafting a special needs trust is whether or not the trust is irrevocable. SSA rules have always provided that the principal of a trust is not an available resource if the beneficiary has no power to revoke the trust and use the principal for his or her own support or maintenance.<sup>180</sup> The POMS state: “Revocability of a trust depends on the terms of the trust agreement and/or on state law. If

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<sup>177</sup> POMS SI 01120.203.B.1.f

<sup>178</sup> POMS §S.I. 01120.203B.3.

<sup>179</sup> See §12.03 *supra* for a discussion of the POMS

<sup>180</sup> POMS §S.I. 01120.200.D.2

a trust is irrevocable, the trust principal is not a resource.”<sup>181</sup> Therefore, the issue is really one of availability. As a general rule of trust law, a trust can be revoked with the mutual consent of the settlor and all of the beneficiaries. SSA reasons that if the same person is the beneficiary and the grantor, he can independently revoke the trust. Therefore, the funds in the trust would be “available.”

The POMS also states: “If an individual (claimant, recipient, or deemor) has legal authority to revoke the trust and then use the funds to meet his food, clothing or shelter needs, or if the individual can direct the use of the trust principal for his/her support, and maintenance under the terms of the trust, the trust principal is a resource for SSI purposes.”<sup>182</sup> In addition, “Even if the power to revoke a trust is not specifically retained, a trust may be revocable in certain situations.”<sup>183</sup> The reasoning of SSA is that state law presumes revocability in certain circumstances. Most states follow the general principal that if a grantor is also the sole beneficiary of a trust, the trust is revocable, regardless of language in the trust document to the contrary.<sup>184</sup>

SSA treats an individual as the grantor of the trust if the trust was established with the person's funds, even if the trust was actually established by someone else acting as his or her agent.<sup>185</sup>

The POMS does note that some states recognize the irrevocability of a grantor trust if the trust contains a named residuary beneficiary.<sup>186</sup> It is good practice to name a specific residual beneficiary to prevent the trust from being considered revocable. SSA acknowledges that some states recognize that naming a particular beneficiary to receive the assets in the trust remaining after the Medicaid reimbursement “preserves the irrevocability of a trust.”<sup>187</sup>

It is important to draft trusts to name a specific beneficiary such as issue, or in default of such issue, then to certain other named persons in order to avoid the SSA argument of “revocability,” which leads to “availability.” Another technique to prevent the revocability issues from arising would be to require in the document that court approval be obtained for termination of the trust. An argument could then be made that the settlor/beneficiary did not have the right to terminate the trust and, therefore, it is not revocable.

The author's preference is to have the (d)(4)(A) trust signed by the court. Some courts are reluctant to do this, because they feel they have no authority to do so.<sup>188</sup> If a court refuses to sign the trust, the court should enter an order establishing the trust and incorporate the trust by reference. This latter practice is currently accepted by the Social Security Administration, but is under study. It is possible that in the future SSA may require the judge's signature on the trust document. Good practice is to submit a brief showing that the Social Security Act specifically

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<sup>181</sup> *Id.*

<sup>182</sup> POMS §S.I. 01120.200.D.1.a

<sup>183</sup> POMS §S.I. 01120.200.D.1.b

<sup>184</sup> POMS §S.I. 01120.200.D.3

<sup>185</sup> POMS §S.I. 01120.200.B.2

<sup>186</sup> POMS §S.I. 01120.200.B.12

<sup>187</sup> POMS §S.I. 01120.200.D.3

<sup>188</sup> 42 U.S.C. §2496p(d)(4)(A)

grants such authority.<sup>189</sup> In Kansas, a trial court refused to establish a (d)(4)(A) trust to allow a conservator to put the disabled son's estate distribution into the trust, stating that “The federal legislation is nothing more than recognition at best.”<sup>190</sup> The Court of Appeals permitted the establishment of the trust finding it contemplated under both federal and state law.<sup>191</sup>

### **2.5.3.2. Notification Requirements**

The trust should contain provisions for notification to the appropriate state agency upon the death of the beneficiary. The trust shall also provide for notice to the county agency for any distributions from the trust for less than fair market value. A state Medicaid agency is a creditor of the trust upon the beneficiary's death, but is not a beneficiary of the trust.

### **2.5.3.3. Discretion**

The trustee must have sole and absolute *discretion* over the use of the trust income and corpus. If the beneficiary has a right to compel the trustee to use the money on behalf of the beneficiary, then the trust is not a special needs trust and the money will be considered “available” for public benefit purposes.<sup>192</sup>

### **2.5.3.4. Third Party Creditors**

A lawyer drafting a special needs trust must be aware that the assets in the trust are protected from claims of a State Medicaid Agency, but are not protected from claims by *third party creditors*.<sup>193</sup> The Restatement (Second) of Trusts provides that an irrevocable, pure discretionary self-settled trust affords no protection from the settlor's general creditors.<sup>194</sup> The beneficiary's creditors can reach the maximum amount, which the trustee has discretion to pay to the beneficiary. This language has been adopted by the Third Restatement of Trusts. The solution to this problem is to draft a trust in compliance with the law of an asset protection trust state, such as Alaska, Delaware, Rhode Island, Nevada, or Utah.

### **2.5.3.5. Prepaid Funeral**

A special needs trust should provide for purchase of a *prepaid funeral*. A Medicaid payback takes priority over the purchase of a prepaid funeral, so failure to purchase a funeral during the lifetime of the beneficiary may result in insufficient funds being available to purchase the funeral.

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<sup>189</sup> See Form 12-14 *infra* for a sample brief

<sup>190</sup> In the Matter of Watkins, 24 Kan. App. 2d 469, 947 P.2d 45 (Kan. Ct. App. 1997)

<sup>191</sup> *Id.*

<sup>192</sup> Social Security Administration Program Operations Manual System (POMS) § S.I. 01120.200.B.1

<sup>193</sup> See the Greater Asset Protection Self-Settled Special Needs Trusts (GAPSNT), Robert F. Collins, 2004 NAELA Symposium, May 20-23, Hilton Head, South Carolina

<sup>194</sup> Restatement of the Law, Second, Trusts, §156

### **2.5.3.6. Termination of Disability**

A final issue to be addressed by the scrivener is what happens when the *beneficiary is no longer disabled*. One solution would be for the trust, by its terms, to convert from a special needs trust to a purely discretionary trust authorizing the trustee to distribute income and principal to the beneficiary in such amounts and proportions and at such times as the trustee, in its sole, absolute and unfettered discretion, shall determine.

A problem would be converting the trust back to a special needs trust if the beneficiary relapsed into disability. In many states this would be a “trigger trust.” A solution, which should not be included in a trust, would be to authorize the trustee, upon termination of disability, to make distribution of the principal and accrued income to the beneficiary. Such language may cause the entire trust to be considered “available” since there would be a circumstance under which the beneficiary may have access to trust assets.<sup>195</sup>

David Lillesand opines that there is no need to do a conversion when a client chooses to stop receiving benefits or is forced from receiving benefits, for example through marriage. Special needs trusts can continue, but free of worries that a particular distribution may disqualify the already disqualified beneficiary. It is Mr. Lillesand’s opinion and the authors concur that it is legal malpractice to terminate a special needs trust and repay Medicaid during the beneficiary’s lifetime. The beneficiary may need nursing home, Medicaid, or other expensive medical care covered by Medicaid in the future. The law does not require a repayment to Medicaid until the beneficiary’s death. It is counterproductive to exhaust the money in the trust by repaying Medicaid prior to the death of the trust beneficiary.

### **2.5.3.7. Exemption from Transfer Penalty**

With respect to transfer rules, a transfer to a self-settled special needs trust is not a transfer subject to the *transfer disqualification rules* for SSI purposes under the Foster Care Independence Act,<sup>196</sup> for Medicaid eligibility purposes,<sup>197</sup> under OBRA '93 or for Section 8 Housing purposes. Actually Section 8 Housing has no transfer rules, but the general rule is that income is imputed to transferred assets for two years after the date of the transfer based on current passbook savings rates as determined by HUD.<sup>198</sup> However, if the assets are placed in a self-settled trust as a result of a settlement or a judgment, there is an exemption from the rule requiring that income be imputed to transferred assets.<sup>199</sup>

### **2.5.4. Approval of Trust**

The trust should be submitted to the Social Security Administration for approval. SSI recipients are under a continuing duty to report any changes in their income, resources, living

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<sup>195</sup> HCFA Transmittal 64 § 3259.6 E

<sup>196</sup> PL 106-169, 1999 HR 3443, codified at 42 U.S.C. 1382b(e)(6)

<sup>197</sup> 42 U.S.C. 1396p(d)(4)(A)

<sup>198</sup> 24 C.F.R. §5.609(a)

<sup>199</sup> HUD Guidebook Regulations and Related HUD materials, Section 1Gb4e

arrangements, or other conditions to SSA.<sup>200</sup> When submitting the trust the following items should be submitted in letter form:<sup>201</sup>

- Client's name and Social Security number
- Receipt of personal injury settlement, inheritance, equitable distribution, or other funds, including copies of:
  - Personal injury closing statement or probate documents showing the date of settlement occurred and the date the trust was funded.
  - The trust agreement.
  - Bank statement showing the deposit to the trustee's account and any disbursements from the account to date.

David Lillesand also suggests including the following:<sup>202</sup>

- SSI spotlight on trust
- SSA POMS section containing the eight steps and action chart to help the CR (claims representative) in analyzing the trust.
- Copy of Medicaid counsel's letter approving the trust, if applicable.

It is also suggested that the trust and supporting documents be submitted by certified mail. The letter would be sent to the local SSA office providing services to the client or to the SSA district office pertaining to the representative payee, if there is a representative payee. The local office can be obtained by the client or through the Social Security office locator at [www.ssa.gov](http://www.ssa.gov) with the client or representative payee's zip code. It is unlikely that SSA will send a letter approving the trust, but they will definitely send a letter if the trust is not approved.

### **2.5.5. Taxation**

In designing a settlement for a disabled tort victim, taxation must be considered. Income taxes, gift taxes, and estate taxes all must be addressed.

#### **2.5.5.1. Income Taxes**

The tax treatment of income received prior to funding the trust as well as income received subsequent to funding the trust must both be considered.

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<sup>200</sup> 20 C.F.R. §416.708

<sup>201</sup> 20 C.F.R. §416.710

<sup>202</sup> Social Security Administration Appeals of Adverse Determination of Your (d)(4)(A) Special Needs Trusts—Practical and Procedural Issues, David Lillesand, NAELA Symposium, May 14-18, 2003.

### **2.5.5.1.1. Income Tax Prior to Funding Trust**

For federal income tax purposes, gross income does not include damages received due to personal injury or sickness.<sup>203</sup> This applies whether the money is received as a settlement or as a result of litigation. The theory is that these are compensatory damages that simply make the taxpayer whole. However, all amount attributable to punitive damages are includable in the taxpayer's gross income.<sup>204</sup> Emotional distress is not considered a physical injury or physical sickness for purposes of exclusion from income. Therefore, to the extent that a payment is made for emotional distress, only the amount paid for medical care contributable to the emotional distress, which are in excess of the payment for medical care, and are includable in gross income.<sup>205</sup>

If an action involves more than one claimant, care should be taken to allocate a settlement among the various claimants. So long as the award is grounded on personal physical injury, it is not includable in the tax of the disabled tort victim, or in the tax of the other plaintiffs, such as a spouse or parent.

If an action is based partially on tort and partially on contract, careful allocation must be made between the two. Only the tort claim is based on physical injury and, therefore, only the tort claim is excludable from gross income. The contract claim would be subject to tax.

### **2.5.5.1.2. Income Post-Trust Funding**

#### **2.5.5.1.2.1. Grantor Trust**

As previously mentioned, generally, a trust can be a simple trust or a complex trust. In a simple trust, the income is paid out to the beneficiary and the beneficiary is taxed on the income. However, by the very nature of a special needs trust, income cannot be required to be paid to the beneficiary. Therefore, the special needs trust cannot be a simple trust.

Since the trust is funded with the beneficiary's recovery at his or her implicit direction, the disabled beneficiary is treated as the grantor for tax purposes. By following the grantor trust rules, the income can be taxed to the individual at the individual's lower tax rate.<sup>206</sup> If the trust is classified as a grantor trust, the income, deductions, and credits of the trust are recorded on the disabled individual's Form 1040, and not by the trust on a Form 1041. This is true even if the trust's earnings are not actually paid to or applied on behalf of the disabled beneficiary. Therefore, the trust document must contain a provision for payment by the trustee of the beneficiary's income taxes. Taxes must be paid directly to the taxing authority and not to the beneficiary.

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<sup>203</sup> I.R.C. §104(a)(2)

<sup>204</sup> I.R.C. §§104(a)(2), 104(b), *as amended by* the Small Business Job Protection Act of 1996, Pub. L. No. 104-188 §1605, 110 Stat. 1755, 1838-39

<sup>205</sup> I.R.C. §104(a)

<sup>206</sup> I.R.C. §§671-677

An issue has arisen involving a structured settlement. A structured settlement is generally considered an asset of the trust. The issue is whether payments from the structured settlement to the trust are considered income to the trust beneficiary. The national SSA office has requested a formal opinion from its general counsel on this matter.

#### **2.5.5.1.2.2. Grantor Trust Rules**

A grantor trust is one in which the grantor has retained a certain level of interest or control in the trust by which the Internal Revenue Service considers the individual to be the owner of the trust assets. The rules are found in the Internal Revenue Code.<sup>207</sup> The Grantor need not be named as grantor in the trust agreement so long as he has provided the assets to fund the trust. Provisions commonly used in self-settled special needs trust to obtain grantor trust status are:

- (1) Retention of a special power of appointment to direct to whom any unaccumulated income in the trust shall be distributed.<sup>208</sup>
- (2) The power to reacquire trust corpus by substituting property of equal value.<sup>209</sup>
- (3) If income may be distributed to the grantor or the grantor's spouse, or held or accumulated for future distribution to the grantor or the grantor's spouse, without the approval or consent of an adverse party.<sup>210</sup>
- (4) Unrestricted power to remove or substitute trustees and to designate any person, including himself, as the replacement trustee.<sup>211</sup>

#### **2.5.5.2. Gift Taxes**

This disabled individual would argue that the trust funding is part of a negotiated settlement and that the primary beneficiary of the trust is the disabled individual. However, if the disabled individual retains a power to dispose of trust assets, such as a testamentary special power of appointment over the remainder upon death, no portion of the funding should be considered a complete gift.<sup>212</sup> Therefore, there is no gift. A complete gift does not occur until the donor gives up dominion and control of the transferred property so that the donor has no power to change the disposition of the property, whether for the donor's benefit or the benefit of

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<sup>207</sup> I.R.C. §§671-678

<sup>208</sup> I.R.C. §674

<sup>209</sup> I.R.C. §675(4)

<sup>210</sup> I.R.C. §677(a)

<sup>211</sup> Treas. Reg. §1.674(d)-2

<sup>212</sup> Treas. Reg. §25.2511-2(c)

another.<sup>213</sup> The reservation of a special power of appointment by the beneficiary/grantor will cause the trust to be included in the estate of the beneficiary/grantor upon death.<sup>214</sup>

### **2.5.5.3. Estate Taxes**

Whether or not the corpus of the trust will be included in the estate of the deceased disabled individual will depend on what powers the disabled individual retained. There is no estate tax for estates of less than \$2,000,000 in 2006.<sup>215</sup> Since the state Medicaid agency must be reimbursed for any expenditures made on behalf of the deceased Medicaid recipient, the strategy is to spend the money on the beneficiary's behalf, rather than to accumulate it in the trust. Therefore, the trust corpus should be less than \$2,000,000 in 2006. An advantage to having the trust corpus included in the estate of the disabled individual is that the beneficiary would receive a "step-up" in basis as to any appreciated assets held by the trust.

With respect to periodic payments, the general rule is that if the disabled individual has the right to receive annuity payments for life, and another beneficiary has a right to receive benefits upon the death of the disabled individual, then the present value of the annuity payments to be received by the remainder beneficiaries is included in the decedent's estate.<sup>216</sup> This could lead to a trap for the unwary, in that if there is a structured settlement with guaranteed payments to a remainder beneficiary, there may be insufficient trust assets to pay the estate tax, which must be paid within nine months of the death of the disabled person. Where there is a structure with guaranteed payments, an analysis should be made as to the likelihood of the disabled person outliving the guaranteed period. An appropriate amount for potential federal and estate tax should be included in the lump-sum portion of the payment. An alternative would be to have the trust name a charitable beneficiary to receive all or part of the trust assets upon the death of the disabled individual. As the assets are depleted and the resulting estate tax liability reduced, the amounts allocated to charitable beneficiaries can be adjusted accordingly. Remember that the amount in the trust payable to reimburse Medicaid is a claim against the estate and will be deductible for federal estate tax purposes.

The best solution to the potential problem of federal estate tax if the beneficiary dies prior to the expiration of the guarantee period is to purchase a commutation rider now available from many insurance companies. The commutation rider will pay the present value of the remaining policy payments, thus providing a source of funds to pay the federal estate tax liability.

## **2.6. Trustee Provisions**

### **2.6.1. Trustee**

The appointment of a proper trustee and the drafting of appropriate removal powers are of critical importance in this type of trust. Very often, the family considers the money to belong to the family rather than to the beneficiary of the trust. The family often wants to be named as

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<sup>213</sup> Treas. Reg. §25.251102(b)

<sup>214</sup> I.R.C. §§2033, 2036-2039, 2041

<sup>215</sup> I.R.C. §§2501, 2505

<sup>216</sup> I.R.C. §2039

trustee in order to be in a position to control distributions. Such an arrangement can be fraught with peril insofar as public benefit eligibility is concerned. It is always advisable to have an independent, non-family member serve as the sole trustee or, at a minimum, as a co-trustee. An independent trustee can be objective and usually has skills, such as investment expertise, that family members lack. Requiring the trust to have an independent trustee also prevents a family trustee from being caught in an endless series of conflicts of interest. Often the court will insist upon the appointment of an independent trustee. If necessary, have a family member serve as co-trustee. The trust document should clearly delineate the responsibility of each of the trustees. Perhaps the appointment of a managing trustee with broad authority, including investment authority, should be considered. The independent trustee could be given authority to invest the money and to control any distributions for in-kind support and maintenance. The family trustee could be given authority to make distributions for purposes other than in-kind support and maintenance.

Whether or not an independent trust can be removed is an important question. The first issue is whether or not the trustee can only be removed for cause, or whether he or she can be removed for any reason at all. If the trustee can be removed for any reason, there should be limitation on the number of times that the removal authority can be exercised in any given period. The next issue is who will have the right to appoint or remove the trustee. The trust document itself should provide for successor trustees. A trust advisor can be given authority to appoint or remove trustees. Often the personal injury attorney is a good choice of trustee advisor because he or she has the confidence of the family. The trust document can also provide that the court retain authority to appoint and remove trustees. As a general rule, the beneficiary should not have the sole authority to appoint or remove a trustee.

One or more successor trustees should be appointed and a procedure should be established for appointment of additional successor trustees.

Choosing a trustee is a crucial decision to be made by the settlor of the trust. The range of options includes:

- Parent, sibling (or other individual)
- Attorney
- Financial institution
- Nonprofit organization
- Co-trustees

Each of these possibilities has potential advantages and disadvantages.

#### **2.6.1.1. Parent/Sibling/Individual**

Where an individual is selected as the successor trustee, it is usually a parent or sibling of the beneficiary. The advantage in naming a sibling as trustee is that the sibling in some cases has a strong filial bond to the disabled person. Another advantage is that the sibling will often work without compensation. The disadvantage in many cases is that the sibling does not have a strong filial bond with the disabled person and, in fact, may strongly resent that person. In many cases,

the disabled person has received a considerable amount of attention and financial resources from the parents. This often causes resentment in healthy siblings. These siblings are definitely not suitable for selection as trustees. Another disadvantage to having a sibling as trustee is that they are generally unskilled in financial management. Siblings seldom have expertise in the area of public benefits law.

In addition, the sibling who is trustee is often a remainder beneficiary where the disabled person has no spouse or children. Remaindermen/trustees face a built-in conflict of interest. To the extent that distributions are made to benefit the beneficiary, they come, ultimately, from the pot which the remaindermen will inherit. Where a parent is named as trustee, there are additional conflicts of interest relating to family expectations.

#### **2.6.1.2. Attorney**

An attorney is often an excellent choice to be the trustee of a Special Needs Trust. The attorney is familiar with the public benefits laws, which distributions are permitted and which are not. The disadvantage to having an attorney serve as trustee is a lack of experience in money management. However, if the attorney has that expertise or is willing to contract that function out to a professional money manager under the Prudent Investor Act, this problem is solved.

#### **2.6.1.3. Financial Institution**

Financial institutions include banks, trust companies, and trust companies established by securities firms. The advantage of a financial institution as a trustee is that these institutions are usually skilled in financial management. Some institutions have expertise in public benefits law or have access to lawyers who have such expertise in this area. Such institutions also have familiarity with very complex federal income tax law pertaining to trusts. A disadvantage is that the financial institution usually has little familiarity with the family and does not know the family's specific goals. This problem can often be minimized by a clear letter of intent from the parent to the institution. Another disadvantage is that the bank charges a fee. The fee is often in the neighborhood of 1% of the first \$1,000,000, and then decreasing as the size of the trust increases. However, this is a small price to pay for expertise in money management.

#### **2.6.1.4. Nonprofit Organization**

Certain nonprofit organizations that advocate for disabled persons have pooled trusts.<sup>193</sup> The advantage of these pooled trusts is that the funds are usually managed by banks or trust companies. Separate accounts are maintained for each beneficiary and an accounting can be made from each subaccount. These nonprofit organizations have expertise in public benefits laws and have a clear sense of the objectives sought by most parents. A disadvantage of a pooled trust is that the trust cannot be specifically tailored to the needs of the individual beneficiary.

Care must be taken in the selection of a nonprofit as some nonprofit organizations are well run while others are not. IF the amount of money involved is small (i.e., less than \$500,000), the financial institution may not be interested in handling the account. Pooled trusts

usually require that a large portion, 50% or more, of the trust assets remaining upon the death of the beneficiary be paid to the nonprofit organization. Nonprofits will often serve as trustee or co-trustee of a nonpooled trust and bring to the table expertise in public benefits, laws, and experience dealing with disabled beneficiaries.

#### **2.6.1.5. Co-Trustees**

Parents establishing trusts for their disabled children and adult beneficiaries of trusts often feel uncomfortable dealing with a stranger, such as a bank or financial institution. One solution is a combination of an individual and a financial institution, attorney, or a nonprofit organization. The right individual has a clear understanding of the family objectives and needs of the disabled person, while the financial institution has expertise in financial management and often public benefits law as well. This is usually a good combination for an estate involving a large sum of money. In estates involving smaller sums of money, the combination of an individual and a nonprofit might make more sense. In instances where there is no family member who is sympathetic to the disabled person, the nonprofit organization can be named as co-trustee with a financial institution or attorney.

#### **2.6.2. Trustee Advisor or Trust Advisory Committee**

A commonly used technique is to name a trustee advisor. A trustee advisor can advise the trustee without actually making decisions. In most cases, the independent trustee will rely on the trust advisor for advice concerning distributions, provided the imposed distributions are not improper.

The trustee advisor's role is to review the financial records of the trust and to meet with the trustee and the family to ensure that the trust is being administered smoothly. He or she serves as a neutral third party with regard to disputes between the trustee and the beneficiary. More appropriate, the trustee advisor can be given the power to remove or replace a trustee. A trustee advisor can be one person or a committee or two or three people.

It is often appropriate for the disabled person's parent to serve as one of the trustee advisors. The personal injury attorney is often a good candidate to be trustee advisor because he or she has the confidence of the family.

The appointment of the trustee advisor gives the family a sense of participation, which gives them a comfort level necessary to accomplish the appointment of an independent trustee.

Another solution to the problem of grantors and beneficiaries feeling uncomfortable with strangers, such as banks and financial institutions, is the establishment of a Trust Advisory Committee ("TAC"). The document can be designed so that the bank or financial institution is the trustee, but a separate TAC is appointed for purposes of advising the trustee as to distributions. The TAC may consist of three to five individuals, which may include a parent or other family member, an attorney, a social worker, a care manager, an accountant, a nurse, a physician, or any combination thereof. The TAC can even be given authority to remove and

replace the professional trustee. Where both parents serve as members of the TAC it is common to have them divide one vote.

### **2.6.3. Trust Protector**

A trust protector is another device to protect the beneficiary and to make the family feel comfortable in dealing with a professional trustee. The trust protector is given the authority to review the actions of the trustee and to remove and replace the trustee where appropriate.

### **2.6.4. Bonding**

The trust should address the issue of bonding. Whether or not bonding should be required is dependent upon the selection of trustee. Where there is an individual trustee, bonding is appropriate because the individual trustee is given broad discretion in the use of trust funds. In cases where there is a financially sound corporate trustee, a bond is unnecessary.

### **2.6.5. Powers of Trustee**

The powers of trustee should be specifically enumerated, and should be individually tailored to meet the needs of the beneficiary and the requirements of state and federal law.

### **2.6.6. Compensation**

The trust should provide for compensation to the trustee and should authorize the trustee to engage the services of special counsel to advise the trustee on public benefits law. The trust should also provide authority to the trustee to retain the services of an independent advisor to establish disability, if required. Compensation for the attorney and their advisor should be provided. Compensation of a care manager should also be seriously considered.

How much compensation should be paid is always an issue. Trustee's compensation is fixed by statute in many states.<sup>194</sup> Alternatively, the compensation of the trustee can be established by a separate written agreement with the trustee. The compensation of special counsel on public benefits law should be negotiated by the trustee, bearing in mind the usual factors that go into the establishment of legal fees. Such factors include the complexity of the matter, the skill of the attorney being retained, and the prevailing rates for similar legal services in the area. A retainer agreement based on an hourly rate is probably the most appropriate. Independent agencies provide services in connection with the establishment of disability. These services usually have rate sheets. A contract should be negotiated by the trustee. Care managers also have rate sheets that are usually based on hourly rates. The hourly rate prevalent in the area should be considered along with the skill and reputation of the care manager.

### **2.6.7. Fees, Taxes, and Administration**

There is no provision in either federal or state law dealing with payment of legal fees, taxes, and administration expenses from these trusts. The trust document should contain reasonable provisions in this regard.

### **3. BEYOND THE TRUST DOCUMENT**

#### **3.1. Third Party Trusts**

##### **3.1.1. Funding**

Estate planning attorneys are regularly called upon to draft trusts for their clients' disabled children. Typically these children are determined to be disabled by the Social Security Administration and are receiving SSI, Medicaid, Section 8 Housing or any one of a number of benefits from the state Division of Developmental Disabilities or equivalent agency. The goal of the parent in establishing the trust is to maintain the disabled child's public benefits while providing an inheritance to enrich the child's life. The inheritance is to supplement, not supplant, public benefits. There is an old adage that there are two ways to screw up a Special Needs Trust: (1) an error on the part of the attorney drafting the trust, and (2) an error on the part of the trustee administering the trust. There is a third way that is much more prevalent. That is inadequate trust funding.

##### **3.1.1.1. Determining the Amount**

Many special needs trusts fail to accomplish the objectives of the parents because they are not properly funded. Most parents want to share their estate equally among their children, but don't realize that their healthy children will be able to work and support themselves, while their disabled child will never be able to work or will only be able to earn limited income and will be unable to provide self-support. Typically, a family with three children, two healthy and one disabled, will simply divided the estate into three equal shares with one share going to the third party special needs trust. No one has made an effort to calculate the disabled child's future expenses or to determine if the disabled child's share of the estate is sufficient to satisfy those needs or even if it is more than whatever would be needed to satisfy those needs.

Many parents of disabled children assume that eventually their disabled child will move to a group home and will be cared for at public expense. Few give any thought to the danger that public benefits, as we know them today, may not exist for the remaining lifetime of the disabled child. There are three ways for the family to calculate the disabled child's future expenses. One would be to retain the services of a life care planner. This is the best solution, but the most expensive. The life care plan could be updated periodically, say every three years. The life care plan would anticipate all of the disabled person's future needs and make cost estimates to satisfy those needs. An inflation factor would be built in.

A less expensive but less accurate way of calculating the disabled child's needs would be for the parents to sit down with pen and paper and write out a lifestyle they want their disabled child to have and calculate the estimated cost themselves. Again, an inflation factor would be built in. What would the disabled child's expenses be for shelter, for food and clothing, for medical needs not covered by private medical insurance, for entertainment and recreation, and other expenses that should be considered and quantified. Once these costs are quantified, an amount necessary to fund the special needs trust to meet the parents' objective for their disabled

child can be established. If the parents believe they can invest the assets at a 4% rate of return, they would need to multiply the annual budget by 25.

A third way to calculate the sum necessary to fund the trust would be to visit the Merrill Lynch and Company website (<http://askmerrill.ml.com/specialneeds>). The Merrill Lynch disabilities group designed this website with a calculator to assist parents in estimating the costs of their disabled child's future needs.

In most instances, once the parents have analyzed the future needs of the disabled child and the cost of meeting those needs becomes apparent, then equally dividing the estate among their children will not satisfy their goal of providing for their disabled child's future lifestyle. In many instances the solution would be for the parents to purchase a second-to-die life insurance policy to fund the trust. Then they might divide their remaining assets equally among their healthy children. The special needs trust can be designed to own life insurance and to remove the policies from the parents' estates for federal estate tax and state estate tax purposes. Appropriate Crummey provisions will be included.

### **3.1.1.2. Retirement Accounts**

Special needs trusts can be funded with retirement accounts. If a person has a disabled child and an IRA, a strategy would be to minimize distributions so as to defer as much of the retirement plan as possible for the benefit of the disabled child upon the employee's death. The disabled child is often in a lower tax bracket than the employee. Therefore, a tax savings will be effected.

The special needs trust is designated as beneficiary to maximize the use of the exemption from estate taxes and to stretch out the distributions from the IRA. There is a distinction in the treatment of income by the IRS and for public benefits programs. A distribution from a special needs trust to pay a private medical insurance premium for a disabled beneficiary of a special needs trust is income to the disabled beneficiary for IRS purposes, but is not considered income for public benefit purposes. This is because the beneficiary did not receive cash or food, clothing or shelter.

The SNT will be subject to trust income rules under the Internal Revenue Code.<sup>217</sup> These rules determine whether trusts are taxed as separate entities and how income and deductions are reported by trusts, including allocation of income between trusts and the trust's beneficiaries.

The primary purpose of the special needs trust is to preserve SSI and the accompanying Medicaid. Since distributions from the trust to third parties that do not provide the disabled beneficiary with food, clothing or shelter, do not cause either disqualification or reduction of the SSI payment. They are not considered income by the Social Security Administration. A person establishing a third party special needs trust should not count on funding it with the proceeds of a retirement plan, because the employee outlive the life expectancy tables and there may be little or nothing left in the IRA to distribute to the special needs trust.

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<sup>217</sup> I.R.C. §§ 641-692.

### 3.1.2. Letter of Intent

In addition to a special needs trust, a Letter of Intent from the parent to the trustee regarding the disabled child is very important.<sup>218</sup> No one knows the child better than the parents. In most cases the child has lived with the parents. The parents know what care has worked and what has not, and what the child may realistically achieve. Even a well-drafted, adequately-funded special needs trust will fail unless the parents outline the parents' wishes and expectations. The Letter of Intent is written in the clients' own words. The Letter of Intent is directed as the successor caregivers and trustees. Copies should be given to the lawyer drafting the special needs trust as well as to the successor caregivers, trustees and social services agencies serving the child with disabilities.

Some parents prefer to fill out a form and others prefer to handwrite or type it in narrative form. In any event, it is always useful to give the parents a copy of a form so that all of the important categories are address. Critical information to be addressed in the Letter of Intent include the following:

- Personal information concerning the child with disabilities
- Information concerning parents of the child with disabilities
- Information concerning the guardian of the child with disabilities
- Information concerning the trustee or trustees of the special needs trust
- A list of contacts including physicians and organizations and individuals providing services
- Information concerning family members who are likely to be involved in the ongoing care of the child with disabilities
- Information concerning pets
- Information concerning friend
- Medical information
- Abilities and disabilities
- Personality characteristics
- Personal care preferences
- Meals

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<sup>218</sup> Letter of Intent Instructions for Successor Caregivers and Trustees, Reginald H. Turnbull, Exceptional Parent Magazine, November 2004.

- Activities
- Hopes and expectations

### **3.2. Self-Settled Trusts**

#### **3.2.1. Alternatives to Special Needs Trusts**

A self-settled special needs trust is not appropriate in every instance where a disabled person receives a tort recovery, an inheritance, or equitable distribution. At the initial contact the special needs trust attorney should make a determination as to whether or not the trust is appropriate and explain to the disabled person and/or the family the alternatives to the special needs trust.

Common reasons for the trust to be inappropriate are that the beneficiary does not qualify. For example, the beneficiary may not be disabled or may be over age 65.

The amount of the net settlement may be too small. For net amounts under \$100,000 it is usually better to seek an alternative to a trust, because of the expense associated with establishing and maintaining the trust. If the net settlement is between \$100,000 and \$200,000, then a trust may or may not be appropriate.

Is there a trustee who is capable of serving and who is bondable? It is difficult to find a professional trustee if the amount of liquid assets to be placed in the trust is less than \$300,000. Family members often do not have the skill or expertise required to administer a special needs trust. In many cases a bond will be required, but the family member is not bondable.

Is the settlement almost exclusively structured? If the beneficiary is not receiving means-tested public benefits and the settlement provides for a monthly income, is a structure either necessary or desirable?

The beneficiary may not be receiving means-tested public benefits, such as SSI and Medicaid, and may not be a candidate to ever receive means-tested public benefits in the future. In those situations a determination should be made whether a special needs trust is appropriate for other reasons. Perhaps a support trust would be adequate.

The three alternatives to establishing a special needs trust are to spend down, to transfer assets or to simply accept the money.

##### **3.2.1.1. Spend Down**

The POMS list a number of transfers for value that will not result in an SSI transfer penalty. These include the following:<sup>219</sup>

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<sup>219</sup> POMS §§S.I. 01150.005 and 00150.120-127.

- Prepayment of room and board
- Prepayment of services
- Lifetime personal service contracts

Under a lifetime personal service contract the disabled person would contract with a third party for in-kind support and maintenance for life in exchange for a lump sum payment. SSA would consider that the third party will provide ISM for the life of the eligible individual and use the table in POMS §S.I. 001150.005.F to determine the total value of the service contract. It would multiply the yearly current market value of the ISM provided by the figure in the “Years of Life Remaining” column, which corresponds to the age (or next lower age) of the eligible individual as of the last birthday at the date the resource was transferred.<sup>220</sup> Prepaying for services would be valued by their frequency and duration under the agreement.

In any event, the cost of establishing and maintaining the trust must be considered against the simple strategy of spending down.

In addition to the strategies outlined specifically in the POMS, the following spend down may be appropriate:

- Purchase of home
- Home improvements, repairs or maintenance
- Tools to perform home improvements
- Installation of burglar alarm or a monitoring/response system
- Advance payment of utilities, homeowner's insurance
- School tuition, books and supplies
- Health and life insurance premiums
- Entertainment (including books, magazines, any vacation travel)
- Handicap van
- Household goods
- Non-refundable airline ticket
- Stereo system
- Television set
- Medical insurance
- Telephone bills
- Newspaper subscriptions
- Furniture
- Services of Care Manager
- Tax payments
- Funeral
- Legal fees
- Transfer to third parties

### **3.2.1.2. Transfer**

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<sup>220</sup> POMS §S.I. 00835.480.D.

If the disabled person is receiving SSI, Medicaid transfer penalties apply. The penalty is a period of ineligibility for SSI. It is calculated by dividing the amount transferred by the maximum SSI payment, including any state supplement. This is usually in the neighborhood of \$600. There is a maximum period of ineligibility of three years. The problem is that if significant sums are transferred and SSI is lost, Medicaid is also lost.

If assets are transferred by a Medicaid recipient whose Medicaid is not linked to SSI but is based on a waiver program, there will be a transfer penalty only if the disabled person is receiving an institutional level of care. This could be care in an institution, such as a nursing home or assisted living facility, or home care provided under some, but not all, waiver programs. If the disabled person is receiving Section 8 Housing, there is no transfer penalty per se, however, HUD will impute interest at the current market rate for a period of two years after the date of the transfer. This may affect the eligibility and rental payment required of the disabled person. Currently the HUD imputed interest rate is 2%.

If assets are transferred by a person receiving SSD and Medicare, there is no transfer penalty. A simple strategy would be to accept the money and immediately transfer it to a relative who could establish a third party special needs trust. This strategy makes sense in situations where a beneficiary is eligible for prescription drug benefits under a state pharmaceutical program and needs such benefits because of extremely high drug costs. It also makes sense where the beneficiary is receiving Medicaid under a waiver program that has no transfer penalty. Two significant advantages to a third party trust are that there is no pay back to the state Medicaid agency on the death of the beneficiary and the funds in the trust do not have to be used for the “sole benefit of” the disabled person. Other family members, including young children, can benefit from distributions.

The POMS authorize certain transfers:<sup>221</sup>

- Transfer of a home to a spouse, child under age 21, disabled child of any age, a sibling or son or daughter under certain circumstances.
- A home transferred to a spouse and disabled child, transfers for purposes other than to qualify for SSI and undue hardship.

Such transfers for value may be permitted under state Medicaid rules as well. An example is that a disabled person may contract with a third party for in-kind support and maintenance for a term of years in exchange for a lump sum payment. Under the POMS SSA would value the compensation received in the form of ISM at its full CMV (monthly or annually depending on the agreement), multiplied by the length of time for which it is to be provided under the agreement. The value of the compensation is not capped at the value of the one-third reduction or the presumed maximum value.<sup>222</sup>

### **3.2.1.3. Accept the Money**

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<sup>221</sup> POMS §§S.I. 01150.005 and 00150.120-127.

<sup>222</sup> POMS §S.I. 00835.480.D.

An alternative for a person receiving SSD and Medicare would be to simply accept the money, because it would have no affect on their public benefits. Another alternative would be to have that person transfer the funds to a third party who would then establish a support trust for the benefit of the disabled person. The support trust would be desirable in situations where the disabled person is not a good candidate to manage money.

Kenneth Brown, of the SSA, has informally opined that SSA does not follow the step transaction rules followed by the IRS and would not object to this strategy.

### **3.2.2. The Settlement**

Upon receipt of the settlement, families often have demands for repayment of the family's accumulated credit card debt, purchasing a new home or modifying an existing home, and obtaining adequate transportation. Repayment of credit card debt is appropriate if the beneficiary is living with the family and it can be shown that the debt is in some way related to the beneficiary's care. Housing can be purchased by the trust, by the beneficiary's family and the trust as co-owners, by having the trust lend the family money for the family to purchase the house, or by having the trustee loan the family money to purchase a portion of the house in co-ownership with the trust. Lending the money from the trust should be considered only as a last resort, because often the family does not feel obligated to make repayment. Purchase of the home by either the trust or the family may result in in-kind income to the beneficiary, but this is usually justified. Transportation usually involves the purchase of a specially equipped van that is wheelchair-equipped with a lift mechanism. Consider having a family member take title to the van so that the trust is insulated from liability claims. The trust can pay for the family member to acquire the van. The trust can pay a share of the maintenance and insurance of the van. If the family is using the van for its own purposes, the family should pay a share of the van's operating expenses as well.

Trustees are often requested to provide funds for respite care for the beneficiary's caretakers, vacations for the beneficiary, and medical care and equipment that supplements government benefits. These are all legitimate requests.

If the beneficiary is a minor, trust assets may not be used to discharge the parents' duty of support. There is a fiduciary rule prohibiting use of a minor child's own resources for the child's non-support needs by the otherwise responsible parent/trustee under the Restatement 3d.<sup>223</sup> The Restatement provides that a minor child is entitled to be maintained by the parents in a manner consistent with the parents' standard of living regardless of the child's own estate.<sup>224</sup> The prohibition against distributions from a trust to discharge a legal obligation of support by a parent do not apply to a situation where there is a single parent.

Payments from a trust to a parent for *extraordinary* care of a disabled child may not be considered the discharge of a legal obligation of support. For example, if a mother stops work to

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<sup>223</sup> Restatement of Law-Trusts Tentative Draft No. 2 (Mar. 10, 1999), Section 50; Weiss v. Weiss, 1996, U.S. Dist. Lexis 2471 (S.D.N.Y. 1996)

<sup>224</sup> Restatement of Law-Trusts Tentative Draft No. 2 (Mar. 10, 1999), Section 50; p.354; Singer v. Singer, 7 Cal. App. 3d 803; 87 Cal. Rptr. 42 (1970)

provide full-time, round-the-clock care for her disabled child, some of this care should be considered beyond the scope of a legal obligation of support by a parent.

Normally in dealing with beneficiaries and families involved with special needs trusts appropriate estate planning documents should be prepared for those beneficiaries having appropriate capacity. These documents include wills, living wills, powers of attorney, and similar documents.

The Settlement of a personal injury claim can be by lump sum or by structured settlement, or by combination of both. Structured settlements must be properly funded in a Special Needs Trust to maintain governmental eligibility for the client.

### **3.2.3. Structured Settlement**

A structured settlement is defined by the National Structured Settlement Trade Association as the payment of money for a personal injury claim where at least part of the settlement calls for future payment. The payments may be scheduled for the claimant's lifetime or a defined period, and may consist of installment payments and/or future lump sums. In order to meet the financial needs of the client, payments can be in fixed amounts or they can vary over certain time periods.

The settlement arrangement generally is one whereby the defendant's liability insurance carrier pays funds, either directly or through an assignee, to a life insurance company for the purchase of an annuity. The annuity produces a stream of income through periodic payments to the plaintiff under predetermined time frames. Most commonly it is utilized in personal injury, medical malpractice, wrongful birth, and death cases. The President of the National Structured Settlement Trade Association claims that in the last two years the Structured Settlement Industry has grown by 50%. Merrill Lynch estimates that in 2001 approximately 7.2 billion dollars of gross premiums were written in the United States for structured settlements.

#### **3.2.3.1. Benefits to the Disabled Client**

There are various benefits the structured settlement can offer the disabled client. Financial security is primary. A structured settlement in the form of annuity payments ensures a fixed monthly stream of income for living and for medical expenses. For families with disabled children or unsophisticated investors, the structured settlement provides great comfort. The disabled person will continue to receive his monthly benefit amount despite adverse economic conditions, changes in interest rates, or spiraling inflation. It also ensures a profession management tool. Studies have shown that many personal injury plaintiffs are unable to manage large sums of money in an efficient manner. Often they are unable to protect their own interests or to provide for their future needs. Additionally, large lump sum awards are often mismanaged by plaintiffs receiving imprudent advice. The structured settlement has the advantage of preserving funds so that they will be available as needed in the future to meet ongoing and continuous medical needs.

#### **3.2.3.2. Tax Implications Regarding the Structured Settlement**

### 3.2.3.2.1. Generally

A structured settlement has multiple tax benefits, which make it attractive to plaintiffs. The Periodic Payment Settlement Act<sup>225</sup> (“PPSA”) enacted in 1982 amended the Internal Revenue Code to ensure that tort claimants may exclude the periodic-payment of personal injury damages from their gross income.<sup>226</sup>

Section 104(a)(2) of the Internal Revenue Code provides that gross income excludes the amount of any damages received on account of personal physical injuries or sickness. This includes damages received by suit, settlement, in a lump sum, or as periodic payments.<sup>227</sup> Therefore, damages received via a structured settlement do not produce an income tax consequence to the plaintiff.

Additionally, when personal injury awards are placed into a structured settlement, even the interest portion is excluded from taxation under Section 104(a)(2) if the taxpayer does not own the annuity, does not have the right to any payment ahead of schedule, and does not have any future payments that are unsecured. If the plaintiff should die and the payments are made to his estate, the payments are also excluded from income tax. In contrast, when a personal injury settlement is received as a lump sum, the interest earned on the recovery is included in gross income.<sup>228</sup> From a tax perspective, the benefit of tax-free interest on personal injury settlements is very appealing.

In addition to ensuring tax-free income on periodic payments, the PPSA also sought to provide more security to the plaintiff in the event of default by the defendant. Prior to PPSA, the plaintiff had to assume the credit risk of the defendant. If the defendant's credit risk was high and he defaulted, the plaintiff could not pursue the annuity issuer for payment because he had no right in the annuity. As a means of providing more security for plaintiffs, Section 130 of the Internal Revenue Code authorizes defendants to make a qualified assignment to a third party to make the future payments to plaintiff.<sup>229</sup>

### 3.2.3.2.2. Qualified Assignments

A qualified assignment under Section 130 requires that:

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<sup>225</sup> Pub. L. No. 97-473

<sup>226</sup> *Owen v. CNA Co.*, 167 N.J. 450, 464 (2001)

<sup>227</sup> 26 U.S.C. §104(a)(2) (1998 and Supp. 2000). This does not include amounts attributable to punitive damages. They are included in the taxpayer's gross income.

<sup>228</sup> Rev. Rul. 79-220 addressed this issue as follows: The exclusion from gross income provided by §104(a)(2) of the Code applies to the full amount of the monthly payments received by A in settlement of a damage suit because A had a right to receive only the monthly payments, it did not have the actual constructive receipt, or the economic benefit of the lump sum amount that was invested to yield that monthly payment. If A should die before the end of 20 years, the payments made to A's estate under the settlement agreement are also excluded from income under §104.

<sup>229</sup> 26 U.S.C.A. §130 (1998 and Supp. 2000); *Western United Life Ass'n Co. v. Hyden*, 64 F.3d 833.30 (3d Cir. 1995)

1. The periodic payment must be fixed and determinable in both amount and time of payment;
2. The periodic payment cannot be accelerated, deferred, increased, or decreased by the recipient;
3. The assignee's obligation cannot be greater than the assignor's obligation; and
4. The periodic payments must be excluded from the gross income of the recipient under Section 104(1) or (2).<sup>230</sup>

A qualified funding asset is defined under Section 130 as an annuity contract issued by a licensed insurance company or an obligation of the United States. In order to qualify, the annuity or obligation must be purchased not more than 60 days prior to the date of the qualified assignment and not later than 60 days after the date of the assignment. In order to obtain the tax benefits of the structured settlement, it is critical that the plaintiff does not have actual or constructive receipt of the funds. If so, the tax benefits are lost.<sup>231</sup>

Under Section 130, the transaction works as follows: the defendant's insurance company pays to the assignee and the structural settlement company, a lump sum and fee, which the insurance company deducts from its gross income. The assignee purchases the annuity to fund the periodic payments to the plaintiff. If the transaction meets the requirements of Section 130, the assignee does not have to report the lump sum as income until it receive the annuity payments. At this time the assignee will have a corresponding offsetting deduction for the periodic payments made to the plaintiff.<sup>232</sup>

The assignment is beneficial to the plaintiff in that he no longer is subject to the financial stability or instability of the defendant or the liability insurance carrier for the term of the structure. A life insurance carrier with an A+ Superior XIV or better rating provides the plaintiff with as much assurance of full completion of the obligation as possible. There are no negative tax implications for the defendant and the assignee.

In order to ensure there is no constructive receipt by the plaintiff, the defendant tortfeasor should purchase the annuity. The parties must place the ownership of the policy in the name of a mutually agreeable person; generally this is the assigned holding company under a qualified assignment. The annuity should be set up in this manner so that the plaintiff is not the owner of the policy. The plaintiff cannot change the beneficiary of the policy, cannot assign it, and cannot accelerate its payments. All future payments must be unsecured. Plaintiff's actual or constructive receipt of the funds will negate the tax benefit of income-free interest. When the Special Needs Trust is established for the plaintiff, the payment recipient must be the trustee of the Special Needs Trust.

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<sup>230</sup> I.R.C. §130(c)

<sup>231</sup> Rev. Rul. 79-220

<sup>232</sup> Owen v. CAN Co., 167 N.J. 450, 465 (2001)

### **3.2.3.3 Mechanics of Funding the Structure**

A structured settlement is usually funded through the purchase of an annuity from a life insurance company. Annuities are inherently flexible and are easily adaptable to the client's needs. For example, the terms of the annuity's beginning date, amount of payments, and length of payments can be negotiated. The annuity can also be structured so that lump sum amounts are paid at periodic intervals. The premium cost of the annuity is based upon the number of years the annuity is in existence. If the annuity is for the lifetime of a disabled individual, a life insurance company will have to estimate the life expectancy of the disabled client. This estimate is done by reviewing the disabled person's medical records. If the life expectancy is shortened based upon the medical diagnosis and records, the disabled client will be "rated up" by the insurance company. This means that he will be treated as an older individual with a shorter life expectancy. The premium will decrease as the client's rated age increases. This will provide the plaintiff's attorney with the opportunity to compare premiums and rated ages to ensure the best possible deal for his client.<sup>233</sup> A structured settlement specialist will usually assist the plaintiff's attorney in getting the most competitive rate for his client.

One of the most important features of an annuity is that it has a guaranteed minimum payment. This ensures that an annuity will continue for a certain guaranteed period of time after the plaintiff dies. The annuity becomes payable to the estate of the plaintiff upon the plaintiff's death.

Non-Section 130 Structured Settlements are also available to disabled clients. Under these structures, a trust funded with tax-exempt obligations such as state and municipal bonds and United States Treasury Bonds is used. The income is exempt from Federal Tax under Section 104 of the Internal Revenue Code. State income is taxable; however, it is usually offset by the deduction available for medical expenses.<sup>234</sup>

### **3.2.3.4 Issues for Consideration**

The elder law attorney should consider the following issues surrounding the Special Needs Trust and settlement:

1. The present and future medical needs of the client;
2. Whether cash or a structured settlement can meet the client's needs;
3. Governmental benefits of the disabled client receives or will likely need some time in the future;
4. Governmental benefits of the family receives;
5. Medicaid and Medicare Liens, which will reduce the settlement;

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<sup>233</sup> See *Persuasion in Settlement Negotiations*, by Howard Nations, Esq. At <http://www.howardnations.com>

<sup>234</sup> See *The Evolution of Non-Section 130 Structured Settlements*, by Richard G. Halpern, *Structured Settlements: Protecting Your Client's Interest and Yours*, ATLA Seminar, May 21, 2002

6. Income, gift, and estate taxes; and
7. Court approval of the settlement.

#### **3.2.3.4.1. The Present and Future Needs of the Client**

In order to properly assess whether a structured settlement, a cash settlement, or a mixture of both is required, the nature and the extent of the present and future medical needs of the disabled client must be determined. A disabled client, whether an adult or a child, often has tremendous medical needs. This is true especially in cases of catastrophic injury or medical malpractice. Consultation with treating physicians, therapists, social workers, care managers, health care providers, caregivers, and family members is necessary to understand what the special needs are. This determines how a structured settlement or cash settlement can meet those needs.

When a structure is utilized, the personal injury attorney should consult with a structured settlement specialist in order to frame the structure. In smaller personal injury matters, which settle prior to trial, the personal injury attorney may not yet have hired experts regarding an assessment of the disabled client's needs. As an advocate working for the disabled client, it is important for the elder law attorney to provide input. For example, consideration should be given to the plaintiff's need for immediate large sum purchases. Housing and transportation are typically high on the list of immediate financial needs. Cash up front for these expenditures may be necessary and should be made available. These financial needs must be considered by the elder law attorney when allocating settlement proceeds.

The future needs of the plaintiff are difficult to assess. Consultation with treating physicians to determine the future medical needs is necessary. Consultation with economists to project the stream of income to meet these medical needs is critical. Often, this assessment has already been completed by the litigator but often it has not. Long-term care of the disabled client should also be addressed. For example, if a caregiver of the disabled person is an elderly parent, a future stream of income will be necessary to pay a new caregiver when the parent dies. When assessing future needs, an elder law attorney also must consider potential advances in medical science. Monies should be made available for unanticipated medical breakthroughs that could potentially improve the life of the client.

Once the needs of the plaintiff are known, the Special Needs Trust can be funded with cash, a structured settlement, or a mixture of both. For small settlements (i.e., less than \$100,000), it is often advisable that the entire amount be taken in a lump sum. For large settlements (i.e., more than \$100,000), there is usually a structured settlement and a cash settlement. A structured settlement alone cannot satisfy the immediate needs of the client.

In allocating the settlement, it may be possible to assign part of the settlement proceeds to a plaintiff other than the disabled client. This can be a family member named on a loss of consortium claim. This sum can also be used for immediate needs. If a Special Needs Trust is used these funds will be shielded from payback to the State.

### 3.2.3.4.2. Governmental Benefits and Liens

All Medicaid liens and Medicare claims must be satisfied prior to funding the Special Needs Trust and before the structured settlement is established.

### 3.2.3.4.3. Court Approved Settlement

For matters in which the disabled person is a minor or incapacitated, a hearing is held following settlement. This is called a friendly hearing. Once the settlement is approved, the court will enter the settlement order and approve the amount of cash or structured settlement to fund the Special Needs Trust. As part of the judgment the trust must be approved. If the court is creating the trust it should be so ordered. The order must also contain any required language by the structured settlement company. Prior to the actual funding of the trust, all liens should be satisfied. It is crucial that the defendant or his assignee purchase the structured settlement. If the plaintiff or the Special Needs Trust purchases the structure, there is constructive receipt and the benefit of tax-free income is lost. It is also critical that the structures correctly name the trustee of the Special Needs Trust as the payment recipient of the annuity payments. If the disabled person is named as the beneficiary, the income will be paid directly to the beneficiary and will be counted for Medicaid purposes disqualifying him from governmental benefits. Income going into the trust will not disqualify the beneficiary.

Lump-sum and structured settlements can briefly be compared as follows:

**Table 4**  
**Lump-Sum and Structured Settlement Comparison**

<i>Issue</i>	<i>Lump Sum Settlement</i>	<i>Structured Settlement</i>
Cost to Defendant	Greater	Lesser
Benefit to Plaintiff	Lesser over Time	Greater over Time
Immediate Needs	Satisfies	Does Not Satisfy
Spend Down	Small Amounts	Not Until Received
Payback	More Available	Less Available
Tax on Earned Income	Yes	No
Estate Tax	100% Includable	Only Guaranteed Portion Available

### 3.2.3.4.4. The Beneficiary

Who should be the beneficiary of the structured settlement on death of the beneficiary of the trust? If the beneficiary of the structure is the trust, the balance of the payments will be used to repay Medicaid. If the beneficiary is a family member, the payback can be escaped. A New York case held that the beneficiary of the structure can be the estate of the trust beneficiary, rather than the trust itself, who are not subject to payback provisions to the State of New York.<sup>235</sup>

<sup>235</sup> Sanango v. New York City Health and Hospitals, Index No. 41383/94 (Oct. 22, 2002 unreported)

There appears to be no restriction in federal law on naming a family member as contingent beneficiary of the guaranteed portion or a structure upon the death of the primary beneficiary of a structure, however, state law must be consulted. The Supreme Court of New York held that there is no authority to consider any guaranteed payment remaining after the death of the trust beneficiary from the trust assets subject to the State's remainder interest.<sup>236</sup> This would have the effect of avoiding a payback to Medicaid since the structure would then be paid to the family member and not to the trust. Only assets remaining in the trust would be required to be paid to Medicaid. The guaranteed portion of the future payment would be includable in the estate of the deceased beneficiary. Consideration should be given to purchasing a commutation rider form the insurance company to provide for funds to pay the federal estate tax.

### **3.2.4. Allocation of the Settlement**

Persons receiving personal injury settlements generally have three wishes: a new home, a vehicle, typically a new handicap van, and a trip to Disney World. In addition, they often have significant debt that needs to be paid off and some money must be set aside for future emergencies. The best way to settle a personal injury case is to begin with these basic needs in mind. A lump sum must be obtained either by allocating a portion of the settlement to other parties, such as spouses or children, or by providing sufficient funds in a lump sum to meet these immediate needs and providing for the balance in either a lump sum or a structure.

In allocating to parents or spouses for derivative claims in a personal injury action, it may be necessary to take the deeming rules into consideration.

One advantage in allocating a portion of the settlement to a structure is that the money will likely last longer. Studies have shown that personal injury settlements last three to five years. If there is a professional trustee, this is not an issue. However, in situations where a family member is to be trustee, monies are often spent foolishly and quickly. If there is a structure, the money is only spent as it is received since the structures are non-assignable.

In evaluating the amount of money that should be placed in a structure and how much money will be received from the annuity payments, consideration should be given to providing a COLA to provide for future cost of living increases and to provide for lump sum payments at appropriate intervals, such as age 18 when monies may be needed for college education, if appropriate.

## **4. ADMINISTRATION OF A SPECIAL NEEDS TRUST**

The rules of administration apply to both third party special needs trusts and self-settled special needs trusts. In order to be effective, a special needs trust needs to be carefully designed and carefully administered. Improper administration can cost the beneficiary his public benefits. The practitioner should consider certain administrative provisions for the document, and should advise the trustee in writing as to trustee's responsibilities.

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<sup>236</sup> IMO Eddie Sanango, Supreme Court of New York, County of Kings, Index No. 41383/94 (Oct. 22, 2002).

#### 4.1. Distributions

Distributions are crucial in preserving public benefits. It is useful not to distribute trust income or principal for food, clothing, or shelter. Examples of permissible trust distributions:

- Home purchase, with rent paid by occupants
- Home improvements, repairs, and maintenance by outside source
- Tools to perform home improvements, repairs, and maintenance by homeowner
- Installation of burglar alarm or monitoring/response system in home
- School tuition, books, and supplies
- Health and life insurance premiums
- Entertainment purposes, including books and magazines; trips to movies, plays, museums, and sporting events; audio/video equipment; hobby supplies, etc.
- Vacation travel, but not lodging, since that is shelter
- Purchase and maintenance of car, or bus passes
- Household goods and other items of personal property of reasonable value
- Payment for items such as cleaning supplies, and paper products
- Telephone expenses
- Dental care, physical therapy, massages, support services, and other medical costs not covered by any benefit programs
- Home care services not covered by another program
- Durable medical equipment, such as wheelchairs
- Gifts to family members (under certain circumstances)

Examples of trust distributions which will reduce SSI benefit:

- Shelter-related expenses (mortgage payments, real property taxes, heating and cooling bills, electricity, water, sewage, garbage collection)

- Groceries or meals
- Items of clothing
- Cash for any purpose

If a trustee provides in-kind support and maintenance that is food, clothing, or shelter, then SSI benefits may be reduced. Examples are payments for a mortgage, homeowner's insurance, rent, real estate taxes, utilities, and garbage removal. Depending on the household in which the individual resides, the benefit may either be reduced by one-third or by the presumed market value of the goods or services. A beneficiary can always show that the actual value is less than the presumed market value. If the actual value exceeds the presumed market value, then the benefit is only reduced by the presumed market value.

Distribution rules for special needs trusts include:

- Do not pay cash to beneficiary
- Do not pay cash to family of beneficiary under 18 years of age
- Distribute to third parties
- Retain public benefits counsel
- Retain care manager
- Try to avoid payment of:
  - Mortgage
  - Rent
  - Real estate taxes
  - Homeowner's insurance
  - Utilities
  - Garbage removal
  - Food
  - Clothing
- Always pay:
  - Income taxes
  - Trustee fees
  - Attorney fees
  - Administrative costs
  - All regularly recurring expenses

Distributions must be made in such a manner that they are not considered to be income to the beneficiary for public benefits purposes. In a leading case, an Oklahoma court determined that the trust in question was an exempt resource; however, distributions might be characterized as income, if they were used for food, clothing, and shelter.<sup>237</sup> The court required the trustee to disclose the character and amount of each disbursement so that the state of Oklahoma could determine whether it is income within the Oklahoma SSI eligibility regulations.<sup>238</sup>

#### **4.2. Counseling Session**

Families often feel that the trust fund is a family bank account. A counseling session should take place with the personal injury attorney, the elder law attorney, the trustee, and the family members to discuss the administration of the special needs trust. The expectations of the family members should be articulated, and limits on the powers of the trustee should be clearly set forth, particularly with respect to what types of distributions are appropriate. Public benefits laws are complicated and change rapidly. In order to avoid constant conflict throughout the administration of the trust, it may be necessary on occasion, but particularly at the outset, to carefully review what can be done by the trustee in relation to the expectations of the family. The family might prepare a proposed budget showing the anticipated expenses for which distribution should be made. These items can be specifically reviewed in the counseling session, and a determination can be made as to which distributions are appropriate and which are not.

It is good practice to have a counseling session involving the disabled person, the family, and the trustee. Prior to the meeting the attorney should send a budget form to the disabled person and/or family for completion. At the end of the counseling session prepare a memo to the family and the trustee outlining what was agreed upon. The family may need to be reminded as to the understandings reached at the counseling session. After the initial meeting an annual meeting should be held with the disabled person, the family, and the trustee.

The disabled beneficiary and family should determine how long the person with disabilities is likely to live and how many years the trust should last. Once this determination has been made, the family and the disabled person should prepare a budget. This exercise begins the process of managing the family's expectations so that the trust assets do last for the lifetime of the disabled beneficiary. Reference should be made to the life care plan where appropriate.

#### **4.3. Trustee Meetings**

Regular trustee meetings should be held to receive input and make decisions concerning distributions. These can be done periodically in the attorney's office. Expectations will be established. An agenda should be maintained and minutes should be provided to all participants. In dealing with (d)(4)(A) trusts the trustee must balance the long- and short-term needs of the beneficiary. Conversely, in third party special needs trusts, the interests of the remainder beneficiaries need also be considered.

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<sup>237</sup> Trust Co. of Okla. v. State Ex. Rel. Dept. of Human Servs., 890 P.2d 1342 (Okla. 1995).

<sup>238</sup> *Id.*

Remind the beneficiary and the family how long they decided the trust should last. Give a report as to the expenditures from the trust during the past year and project how long the trust will last based on continuing distributions at those levels.

Trustees should always avoid distributing cash to the beneficiary. Under the POMS, cash distributions are treated as countable income.<sup>239</sup> All distributions should be made to third parties on behalf of the beneficiary and should be limited to the extent possible to items which cannot be considered food, clothing, or shelter, or converted to use for food, clothing, or shelter. If the distributions are in-kind distributions of food, clothing, and shelter, they are considered In-Kind Support and Maintenance (ISM) and are income, which results in a reduction of benefits.<sup>240</sup>

The trustee needs to make distributions that do not violate the income or resources rules of the applicable benefit programs. Part of the settlement of the personal injury case should involve counseling sessions with the trustee, the disabled individual, and the family. The trustee must understand that direct distributions to the beneficiary will be income to the beneficiary for SSI purposes so that the trustee should not make direct distributions. Such distributions would reduce SSI dollar-for-dollar. A relatively small distribution would eliminate SSI for the month in which the distribution is made and, therefore, cause a loss of Medicaid. If the distribution is large and remains unspent, it then becomes a resource as of the month following distribution and may cause a continuing loss of Medicaid.

#### **4.4. Titling of Trust Assets**

Trust assets must always be titled in the name of the trust and never in the name of the beneficiary. If trust assets are titled in the name of the beneficiary, they become the beneficiary's resources and will disqualify the beneficiary from public benefits. Assets titled in the name of the trustee are clearly assets of the trust and are subject to the terms of the trust, which make those assets unavailable to the beneficiary. For example, assets might be titled "Metropolitan Trust Company, Trustee of the John Jones Irrevocable Trust dated July 1, 1998."

#### **4.5. Surety Bond**

If there is no corporate trustee, a trust document might include a provision requiring a surety bond for the individual. Since the trustee has very broad discretion as to how the trust income and principal are to be used, a surety bond might be considered as a way to safeguard trust assets. The bond should be in an amount equal to the trust assets. The amount of the bond should be reviewed annually. The premiums can be paid by the trustee from trust income.

#### **4.6. Accountings**

The trust document may also provide for annual accountings by the trustee. This enables the trust beneficiary and non-trustee family members to scrutinize the performance of the trustee.

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<sup>239</sup> POMS § S.I. 01120.200.E.1.a. See § 12.03 [J] [1] *supra*.

<sup>240</sup> POMS § S.I. 01120.200.E.1.b.

#### **4.7. Investments**

The trustee has an obligation to invest the trust assets in a manner designed to achieve the objectives of the trust. As a general rule, the duties of a trustee cannot be delegated. However, the Prudent Investor Act (PIA) in some states authorizes the delegation of the investment function by a trustee and relieves the trustee of liability for investment performance under certain circumstances.<sup>241</sup> The practitioner should consult the state Prudent Investor Act in his jurisdiction.

An analysis must be made of the degree of risk which the beneficiary can tolerate, as well as the cash-flow needs to the beneficiary. Expenses such as insurance premiums for a home or a van, medical expenses not covered by other sources, and necessities not covered by other sources must be considered in analyzing the beneficiary's cash-flow needs. The trustee is often required to educate the beneficiary and his or her family as to what are appropriate investment vehicles and expectations.

#### **4.8. Recordkeeping**

It is crucial that the trustee maintain accurate records of assets, income, and disbursements. SSA reserves the right to review all disbursements made to or on behalf of the beneficiary.<sup>242</sup> The trustee's records must clearly reflect the payee of each distribution and the purpose for which it is made. If a challenge is made by SSA that a distributions constitutes income to the beneficiary, the trustee must have accurate records to refute the challenge.

#### **4.9. Reporting Requirements**

SSI requires certain reporting for all SSI recipients.<sup>243</sup> The beneficiary must complete these reports in a timely manner, so that the beneficiary's eligibility will continue. Existence of the special needs trust must be reported to the SSA and a copy provided, if requested. Any change in the beneficiary's address, employment, living arrangements or income, including receipt of direct or ISM by the trust must be reported.

#### **4.10. Appeals**

If the beneficiary receives notice of an adverse action, the decision must be appealed within ten days in order to maintain benefits during the appeal period.<sup>244</sup> The trustee should request copies of all communications from SSA to the beneficiary.

#### **4.11. Budgeting**

A trustee should establish a budget for the trust and the beneficiary at the outset of the relationship. The trustee will estimate the annual income on a conservative basis. Any large expenditures, such as for housing or transportation, should be deducted prior to estimating

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<sup>241</sup> Unif. Prudent Investor Act §§ 1-16, 7B U.L.A. (1994).

<sup>242</sup> 20 C.F.R. §§416.1322-416.1330.

<sup>243</sup> 20 C.F.R. §§416.1321(c).

<sup>244</sup> 20 C.F.R. §§416.1407-416.1422.

income. Taxes and trustee's fees must then be deducted. The remaining income should then be broken down for use by the trustee in an appropriate manner on a monthly basis.

#### **4.12. Tax Responsibilities**

The trustee is responsible for preparing and filing an IRS form 1041 for the trust, unless the trust is a grantor trust. The trustee should also prepare and file a state form 1041 or equivalent, and file an IRS form 1040 for the beneficiary, and a state form 1040 or equivalent for the beneficiary in situations where the beneficiary is unable to file those tax returns for himself or herself.

#### **4.13. Circular Deeming**

If a trust pays a parent for the “extraordinary care” of a disabled child, the result may be circular deeming. SSA has no restriction on the payment from the trust to the parent for the extraordinary care. However, income to the parent is deemed to the child and may cause the child to lose SSI and if the child loses SSI, Medicaid may also be lost. The best solution is to get the minor child on a Katie Beckett waiver program where deeming rules do not apply. The same situation would arise if the trust pays the parent rent for the disabled child. In fact, any distribution from the trust to the parent constituting income to the parent will be deemed to the child and may cause a loss of public benefits.

#### **4.14. Credit Cards**

In appropriate cases the trust beneficiary should obtain a credit card. The credit card should have a fairly low limit so that it is not abused. Credit cards are loans, and loans are not considered income for SSI purposes.<sup>245</sup> If credit cards are used to purchase food, clothing or shelter, these are considered ISM and result in a reduction of the SSI benefit. It is often difficult to obtain a credit card for disabled beneficiaries, because they often have a very poor credit history. It is also difficult to obtain a credit card in the name of a trust.

#### **4.15. Medical Insurance**

One of the most pressing needs for disabled beneficiaries is medical care. It is crucial that they obtain some form of medical insurance.<sup>246</sup> Options include the following:

- *Private Medical Insurance.* Typically, the only source of private medical insurance at regular rates is through the parent’s coverage with the parent’s employer. Parents of such child must make every effort not to lose their jobs.
- *COBRA.* The Consolidated Omnibus Budget Reconciliation Act of 1996 allows former employees and their dependents to continue the employer’s

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<sup>245</sup> 20 C.F.R. 416.1103(f).

<sup>246</sup> Health Insurance and COBRA Issues Collateral to SNT's and Settlements, Roger M. Bernstein, Stetson University College of Law, Special Needs Trusts IV (Oct. 18, 2002).

coverage for a limited period of time, commonly 18 months. However, if the employee became disabled within 2 months of the qualifying event causing him to lose medical insurance coverage, COBRA coverage may be extended for 29 months. If the former employee died, divorced, or became entitled to Medicare, then the employee's dependents are eligible for 36 months of coverage.

- *State-Mandated High Risk Pools.* Many states have high-risk pools to cover persons who are uninsurable in the private market. This coverage often tends to be very expensive.
- *Medicare.* Medicare is only available to persons under 65 if they are disabled and have 20 quarters of coverage. If they receive SSD, then two years after the determination of disability they are entitled to Medicare. Persons receiving Medicare should obtain a Medicare supplement policy. There is usually a very limited open enrollment period to obtain this coverage after which it becomes impossible to obtain because of pre-existing conditions.
- *Medicaid.* Persons receiving SSI also receive Medicaid. Other ways of obtaining Medicaid are through state Medicaid waiver programs, including various KidCare programs available in many states. Eligibility rules vary. A Katie Beckett waiver program is very desirable, because the income and assets of the parent are not deemed to the children. Slots tend to be extremely limited.

#### 4.16 Letter of Instructions to the Trustee

A law firm preparing a special needs trust should always draft a letter of instructions to the trustee explaining how the trust needs to be administered.

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