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R&D
Estate Planning Research & Developments

Special Needs Trust Planning

Estate planning can be especially complicated for the parents of a disabled child or for others who wish to provide for a disabled individual. In addition to having the usual estate planning documents in place, the parents or guardians of a special needs child should consider establishing a "special" or "supplemental" needs trust (SNT).

In the special needs context, estate planning frequently centers on arranging for the child's care and support after the parents' death. The planning needed to provide for the child's future can be complex, encompassing issues ranging from medical care and living arrangements to education and employment. From a financial perspective, there is often a desire to provide for the child without compromising access to needs-based government benefits, such as Medicaid and Supplemental Security Income (SSI).

The Challenge with Traditional Trusts

A standard trust created to provide for a child's health, education, maintenance, and support may generate unanticipated challenges. For instance, applicable federal, and perhaps state, law may require that all trust assets be expended before the affected child may qualify for any government benefits. Or, federal law may require repayment of benefits previously paid in a situation where trust distributions resulted in a violation of Medicaid eligibility criteria.

Public Benefits

Needs-based government benefits are available to disabled individuals with limited financial resources and income. Administered by the Social Security Administration, the Supplemental Security Income (SSI) program pays a small monthly benefit (up to $674 to an eligible individual and $1,011 to an eligible couple in 2010). Some states supplement the federal SSI benefit with additional payments. Importantly, SSI beneficiaries in most states can also receive medical assistance under Title XIX of the Social Security Act (Medicaid) to pay for hospital stays, doctor bills, prescription drugs, and other health costs.

Eligibility Criteria

Eligibility for SSI benefits depends on a person's available income and resources. Income is defined broadly to include both earned and unearned income, as well as inheritances, gifts, and in-kind contributions of food, shelter, etc. (20 CFR Sec. 416.1102). Small amounts of certain types of income are excluded in the calculation of available income. The states determine income eligibility differently, but, in general, where a disabled individual's income exceeds the limit, benefits are reduced or eliminated.

As for resources, an SSI recipient generally cannot have more than $2,000 of assets ($3,000 for married individuals who are both eligible) (42 USC Sec. 1382(a)(1)(B)). Resources include cash, liquid assets, or any real or personal

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property that the individual owns and could convert to cash to use for support and maintenance (20 CFR Sec. 416.1201). Certain assets are excluded (e.g., a personal residence), and limits vary somewhat from state to state. Where resources exceed the applicable limit, SSI benefits are not available to the individual.

In many states, anyone receiving SSI benefits is also eligible for Medicaid coverage. Other states have standards that are more restrictive than the SSI requirements. States also differ as to whether their Medicaid programs offer coverage to "medically needy" individuals, generally defined as individuals who cannot afford to pay for medical and long-term care but have income and resources in excess of the general criteria for Medicaid eligibility. So-called "income-cap" states do not offer coverage to medically needy individuals. In income-cap states, anyone with income exceeding 300% of the monthly SSI benefit amount cannot qualify for Medicaid.

The Impact of OBRA '93

In 1993, Congress amended the Medicaid rules relating to trusts. The Omnibus Budget Reconciliation Act of 1993 (OBRA '93), P.L. 103-66, amended federal law to allow a special needs trust to be established for a disabled individual without compromising his or her access to SSI or Medicaid.

If properly drafted, the assets of a special needs trust are not counted as available resources for purposes of determining whether the trust beneficiary is eligible for benefits. A special needs trust can be either self-settled or established by a third party, and it may be an inter vivos or testamentary trust. The type of trust that should be drafted generally depends on whose assets are funding the trust, in addition to the age and circumstances of the trust beneficiary.

Self-settled Trusts

A person is considered "disabled" for purposes of the Medicaid self-settled trust rules if he or she meets the definition of disability for SSI eligibility purposes. Thus, an individual age 18 or over must be 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 12 months. A child under age 18 meets the definition if he or she suffers from any medically determinable physical or mental impairment of comparable severity (42 USC Sec. 1382c(a)(3)).

The income and corpus of an irrevocable trust created with a disabled individual's own assets (a self-settled trust) will not be counted for Medicaid eligibility purposes if the trust meets the requirements set forth in 42 USC Sec. 1396p(d)(4)(A). A parent, grandparent, legal guardian, or court must establish the trust. Even if competent, the disabled individual may not create the trust. The disabled individual must be under age 65 at the time the trust is created and may not be given a right to compel the trustee to use trust assets for the individual's benefit. After the trust is established and assets are assigned to it, the assets do not count for Medicaid eligibility.

If the trust holds assets at the time of the individual's death, those assets generally must be used to reimburse the state for Medicaid benefits paid. In addition to Medicaid reimbursement, trust funds may be used for the payment of estate taxes and reasonable fees for administration of the trust estate. Medicaid must be repaid before the trust can disburse funds for funeral expenses and the repayment of other debts and before residual beneficiaries may receive funds from the trust. The Medicaid payback should be expressly provided for in the trust document.

Pooled Trusts

Another type of trust arrangement that may be established for a Medicaid beneficiary is a pooled trust under 42 USC Sec. 1396p(d)(4)(C). Such trusts are established and managed by a nonprofit organization and funded with a disabled individual's own resources. While each beneficiary has a separate account under the trust, the assets of the trust are pooled for investment purposes.

A key distinction exists with a pooled trust as compared to a traditional self-settled trust: Contributions to the account of a beneficiary of a pooled trust may be made even after the beneficiary turns 65. However, establishing a pooled trust account for a disabled individual who is age 65 or older could result in the imposition of a transfer "penalty" under 42 USC Sec. 1396p(c) in the form of a period of ineligibility for long-term care benefits under Medicaid. If assets remain in the account upon the beneficiary's death, the assets must be used to reimburse the state for Medicaid benefits paid before any amounts may be distributed to heirs, legatees, and remainder beneficiaries.

Third-party Trusts

Designed to supplement — but not to duplicate or reduce — Medicaid benefits, a third-party supplemental needs trust can be established by an individual for the benefit of a disabled person. Because the trust is not funded with the disabled individual's own assets (unlike a self-settled trust), it is not required to have a Medicaid payback provision. Any assets remaining in the trust when the disabled beneficiary dies can be distributed to the

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remainder beneficiaries designated by the trust grantor. Where a disabled individual is the beneficiary of both a self-settled *and* a third-party special needs trust, the assets of the trusts should not be comingled, as this could result in all the assets becoming subject to the Medicaid payback requirement.

Trust Distribution Requirements

The trust instrument should not direct the trustee to provide for the disabled beneficiary's health, support, and maintenance. Beyond jeopardizing Medicaid availability, such a provision may cause a state to assert a claim against the trust beneficiary's estate for the cost of care. Instead, consider drafting a provision (if compatible with state law) that expressly prohibits the trustee from making payments for the disabled beneficiary's basic support and medical care. Alternatively, it may be sufficient to give the trustee complete discretion regarding trust distributions.

Practical Planning Considerations

The trust may provide a disabled individual with a range of products and services that will enhance his or her quality of life. For example, if help is needed with the activities of daily living, such as bathing and dressing, the trust could provide the funds to hire a personal assistant. Other possible uses of trust fund assets include paying for such items as residential improvements to make the trust beneficiary's home more accessible, upgraded accommodations in a skilled nursing facility exceeding what Medicaid will pay for, specially equipped vehicles (such as a wheelchair-accessible van), fees for professional services, vacations, recreational activities, education, and training. The trust should not, however, pay for items covered by government benefits, since the trust's purpose is purely supplementary in nature.

Conclusion

Providing financial assistance to a disabled individual without jeopardizing the availability of public assistance can be a substantial challenge. Special-needs planning is a complicated process that requires the balancing of multiple issues. A special needs trust may be an appropriate solution for your client's circumstances. Let us know if we can be of assistance to you or your clients.

Recent Developments

Delay in Filing Extension Request Was Justified

P and **W's** prenuptial agreement included provisions for the benefit of **W** in the event of **P's** death. **P** died shortly after his marriage to **W**. **P's** executor did not file Form 706 within the required nine-month period following **P's** death. However, approximately 10 months after **P's** death, **P's** executor filed IRS Form 4768, *Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes*, and made a payment of $1.8 million in estimated federal estate tax. The IRS denied the late filed extension request. **P's** estate ultimately filed Form 706 within 15 months of **P's** death. The IRS subsequently assessed penalties and interest against **P's** estate for the estate's failure to timely file Form 706. **P's** estate filed suit in federal district court, seeking a refund. **P's** estate contended that the IRS should have afforded the estate additional time to prepare tax return documents since "Schedule A" of **P** and **W's** prenuptial agreement could not be located and it was material to the federal estate-tax calculation; there was discord among **W** and **P's** three daughters from a prior marriage; and **P's** estate was highly illiquid. The IRS did not document and provided no reason for the denial of the extension beyond the fact that Form 4768 was filed late. Since the IRS had failed to document any reasons for the denial, it was not possible for the court to review the IRS's decision, as authorized by statute. The court ruled in favor of **P's** estate, ordering the IRS to refund the interest and penalties paid. The court found that the IRS had the right to grant — and should have granted — an extension under Reg. Sec. 20.6081-1(c) and that the IRS abused its discretion in denying the estate's extension request (*Estate of Proske v. United States*, DC-NJ, 5/25/2010).

Postmortem Designation of IRA Beneficiary Ruled Invalid

H and **S's** revocable living trust provided for various trusts to be created at the death of the first of **H** or **S**. **H** and **S** subsequently amended the living trust in regard to the payment of qualified retirement plan proceeds to the trust. Specifically, **H** and **S** indicated that the trustee should follow the minimum distribution rules under IRC Sec. 401(a)(9) when permitting withdrawals from the retirement accounts. Upon **S's** death, **H** named his daughters, in their capacity as trustees of a credit shelter trust created under the living

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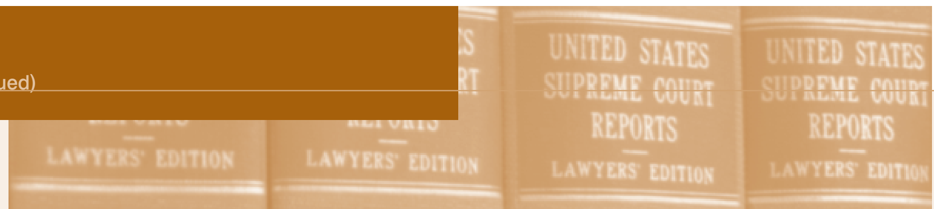

trust, as beneficiaries of his IRA. **H** subsequently died after his required beginning date for RMD purposes under IRC Sec. 401(a)(9)(C). Under the living trust's terms, all trusts thereunder became irrevocable upon **H's** death and were consolidated into two protective trusts for the benefit of the two daughters. The daughters sought and received in state court a judicial modification of the living trust to provide, in part, that IRA proceeds were to be distributed directly to the protective trust beneficiaries. Their intention was to meet the requirements under Reg. Sec. 1.401(a)(9)-4, which could make it permissible to "look through" the trust in determining who, if anyone, is the IRA's designated beneficiary. The IRS determined that the state court's retroactive modification to the trust's terms did not apply for federal tax purposes. Such a court-ordered modification would only be valid, the IRS reasoned, if it were specifically authorized under the Internal Revenue Code. The IRS also analyzed whether the credit shelter trust, as beneficiary of **H's** IRA, qualified for look-through status. Since the trust document permitted the daughters to appoint trust income or principal to charitable entities and only *individuals* can be designated as beneficiaries for IRC Sec. 401(a)(9) purposes, a designated beneficiary did not exist. Accordingly, **H's** IRA must be distributed over his remaining life expectancy (PLR 201021038, 5/28/2010).

Taxation of Division and Termination of QTIP Trust

In her will, **D** provided for the creation of a marital trust, **T**, for the benefit of **Y**, her spouse. Under **T's** terms, **Y** is to receive all of **T's** net income and **T's** trustee may distribute principal to **Y** for certain purposes. **D's** will also provided that upon **Y's** death, **T's** principal will be distributed to **D's** issue, as **Y** appoints in his will. Absent **Y's** appointment, the remaining principal will be divided among **D's** children, to be held in separate trusts. The trustees of such trusts may distribute principal and/or income as the trustee generally deems necessary for a beneficiary's education, maintenance, and support. Principal distributions are scheduled to be made at various stages, and the beneficiary has a testamentary general power of appointment over any remaining balance. **D's** personal representative made a QTIP election under IRC Sec. 2056(b)(7) with respect to **T**. **Y** and the children later petitioned a state court, seeking an order authorizing the termination of **T** and its division into two trusts. **Y** had determined that he did not need principal distributions from **T** and did not want to exercise his testamentary power of appointment over **T**. The court subsequently issued an order granting the request and authorized **T's** division into two trusts, **T1** and **T2**. **T1** would hold the actuarial present value of **Y's** income interest in **T**, and **T2** would hold the balance of **T's** property. The parties agreed that **Y's** gift of his qualifying income interest would be net of federal gift tax and that **Y** would exercise his right of recovery under IRC Sec. 2207A(b) to recover the gift tax attributable to the gift. In addition, **Y** will renounce his testamentary power of appointment over **T's** property. The IRS ruled that **Y** will be treated as having made a net gift of the remainder interest in **T** and as having made a net gift of the difference between the value of his qualifying income interest in **T** and the value of the assets distributed to him. No portion of **T's** property will be included in **Y's** gross estate pursuant to IRC Sec. 2044 (PLR 201024008, 6/18/10).

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