

# **SPECIAL NEEDS TRUSTS**

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## SPECIAL NEEDS TRUSTS

### I. Introduction

The focus of this presentation is on trusts used for people who are elderly or disabled that will allow them to qualify for public assistance benefits, including Medicaid and Supplemental Security Income. See Appendix A for a brief description of public assistance benefits which may be affected by the use of a Special Needs Trust.

The challenge of drafting such trusts is to design them so that the assets held in the trusts are not deemed to be “available resources” to the trust beneficiary. “[R]esources are considered available both when actually available and when the applicant or recipient has a legal interest in a liquidated sum and has the legal ability to make such sum available for support and maintenance.” 45 C.F.R. § 233.20(a)(3)(ii)(D) (also cited as authority in *Tidrow v. Dir., Mo. State Div. of Family Servs.*, 688 S.W. 2d 9, 13 (Mo. App. E.D. 1985); *Couch v. Dir., Mo. State Div. of Family Servs.*, 795 S.W.2d 91 (Mo. App. W.D. 1990); *Mo. Div. of Family Servs. V. Wilson*, 849 S.W. 2d 104 (Mo. App. W.D. 1993)).

### II. Goals of Special Needs Trusts:

- A. To preserve the individual’s eligibility for government benefits.
- B. To supplement those benefits so as to improve the quality of the individual’s life.
- C. If possible, to preserve family wealth for equitable distribution among all family members.

### III. How Trusts Impact Medicaid Eligibility

When a person applies for Medicaid benefits, he or she must disclose all assets owned and income being received. In addition, if the person is the beneficiary of any trust, the Family Support Division will review the details of that trust. This is the state agency that administers the Medicaid program in Missouri.

Unless the trust meets certain strictly construed criteria, the corpus of the trust will be deemed to be an “available resource” to the person. This means that it will count toward the maximum amount of nonexempt resources the person can have and still qualify to receive Medicaid long-term care benefits. In Missouri, this is less than \$1,000. § 208.010.2(4), RSMo 2000.

If it is determined that the person has available resources that exceed the maximum amount allowed, he or she will be denied Medicaid assistance until the excess resources disappear or are “spent down” to an amount below the maximum.

#### IV. How to Categorize Trusts

##### A. Types of Trusts

A trust used for a person who has a disability will usually be designed to keep the trust corpus from being deemed an “available resource” to the beneficiary so that it does not disqualify the beneficiary from being eligible for public assistance benefit programs.

Unfortunately, there is no universally accepted generic name for these trusts. Over the years, numerous authors, governmental agencies, and courts have used various names, including “special needs trusts,” “supplemental needs trusts,” “supplemental care trusts,” “supplemental benefit trust,” and many others. Probably the most recognized name is “special needs trusts” although this actually is merely one of the distribution standards that can be used for this type of trust. The best description of a trust which contains the proper distribution standard is “supplemental benefit trust.”

Throughout this outline, the terms “supplemental benefit trust” and “special needs trust” are used interchangeably to refer to the kind of special needs trust which enables the beneficiary to continue to qualify for governmental benefits and not the kind of special needs trust which would result in disqualification.

A supplemental benefit trust can be established by either the beneficiary (self-settled) or someone other than the beneficiary (third-party settled).

Normally, a supplemental benefit trust will be classified as a “special needs trust” although in some cases a “purely discretionary trust” will also suffice. But a “support trust” will typically be deemed to be “available” for Medicaid purposes. Although Missouri courts have ruled that a “discretionary support trust” is an exempt resource for Medicaid eligibility purposes, most states deem such a trust to be available.

##### B. Who Established the Trust

When designing a trust for a person receiving public assistance benefits, it is important to distinguish between self-settled trusts and third-party settled trusts. The public assistance programs treat these types of trusts quite differently.

The “settlor” of a trust is not just the person who signs the trust to establish it and is referred to in the trust document as the settlor (or grantor, trustor, or some similar title). According to well-established law, a person is considered a settlor of a trust if that person’s assets are used to fund the trust. RESTATEMENT (SECOND) OF TRUSTS §§ 3 and 17 (1959); 42 U.S.C. §1396p(d)(2)(A); Program Operations Manual System (POMS) § SI 01120.200.B, available at <http://policy.ssa.gov/poms.nsf/aboutpoms>; *Masterson v. Dep’t of Soc. Servs., Div. Of Family Servs.*, 969 S.W.2d 746 (Mo. Banc 1998).

## 1. Third-Party Settled Trust

A third-party settled trust is a trust that is not executed as “settlor” by the beneficiary of the trust and is not funded with any assets that belong to the beneficiary. An example is when a parent transfers the parent’s assets to a trust for the benefit of the parent’s child. This will typically occur at the parent’s death as part of the parent’s estate plan, but such a trust could also be established and funded during the parent’s lifetime. Another example may be an adult child establishing a trust for the benefit of a parent.

Technically, it is also a third-party settled trust when a person establishes a trust with the person’s separate assets for the benefit of his or her spouse. But, unless established by the will of the person, such a trust is deemed to be self-settled for both SSI and Medicaid purposes. 42 U.S.C. § 1396r-5; 42 C.F.R. § 435.121(a)(3)(i). Both of these programs deem all assets of either spouse to be available to the other spouse. 42 U.S.C. § 1396p(e)(1); 42 C.F.R. § 435.602(a)(1). The courts in Missouri applied this in *McKenzie v. State of Missouri, Department of Social Services, Division of Family Services*, 983 S.W.2d 196 (Mo. App. E.D. 1998).

## 2. Self-Settled Trust

A self-settled trust is a trust that holds any assets formerly owned by the beneficiary of the trust. This is true even if the beneficiary did not sign the trust as settlor. In addition, for Medicaid and SSI purposes, a trust is deemed to be self-settled if any assets of the beneficiary’s spouse are transferred to the trust. 42 U.S.C. § 1396p(d)(2), (e)(1); POMS § SI 01150.110.E. The only exception to this is if the spouse establishes the trust by a last will and testament. 42 U.S.C. § 1396p(d)(2)(A).

The three types of Self-Settled Trusts are:

- a. Medicaid Payback Trusts
- b. Pooled Trusts
- c. Miller Trusts

A table which compares the differences between a Third Party Trust and a Self-Settled Trust is attached as Appendix B.

## V. Nontax Drafting Issues of Supplemental Benefit Trusts

### A. Important Provisions in Supplemental Benefit Trusts

#### 1. Intent of the Settlor

Whether self-settled or third-party settled, it is recommended that a supplemental benefit trust clearly recite the following (*see Tidrow v. Dir., Mo. State Div. of Family Servs.*, 688 S.W. 2d 9 (Mo. App. E.D. 1985)):

It is the settlor's intent that the trust assets not be deemed "available" to the beneficiary for public assistance benefit purposes.

a. It is the settlor's preference, subject to the trustee's sole and absolute discretion, that the trust estate only be used to supplement, not supplant, any benefits the trust beneficiary is receiving from any other source, including, but not limited to, public assistance benefits such as Supplemental Security Income (SSI) and Medicaid.

b. It is the settlor's preference, subject to the trustee's sole and absolute discretion, that the trust estate not be used for the basic support of the beneficiary.

c. It is the settlor's preference, subject to the trustee's sole and absolute discretion, that no distribution be made from the trust that will cause the beneficiary to lose public assistance benefits.

d. The trust estate cannot be used to repay any governmental agency or program for any public assistance benefits the beneficiary may have received. (Note: this prohibition will not be included in a d4A or "medicaid payback" trust (a trust authorized by 42 U.S.C. § 1396p(d)(4)(A)).

#### 2. Discourage Distributions for Food, Clothing, and Shelter

Some supplemental benefit trusts will specifically prohibit the trustee from distributing for the beneficiary's food, clothing, and shelter. The primary reason for this prohibition is to not conflict with the SSI rule that any such distributions will cause a corresponding reduction in SSI benefits. If the distribution is in-kind, the SSI reduction will be limited to the value of the distribution, or one-third of the maximum SSI payment then in effect, whichever is less. 20 C.F.R. §416.1130(c). "In-kind" distributions are referred to as "in-kind support and maintenance." This includes any food, clothing, or shelter distributed to the SSI recipient and paid for by another. The fair market value of such items is deemed to be income for SSI purposes. 20 C.F.R. § 416.1130(b). In-kind support and maintenance is valued at the one-third-reduction rule, or the presumed-value rule, depending on the living arrangements of the SSI recipient.

### 3. Spendthrift Provision

In *Missouri Division of Family Services v. Wilson*, 849 S.W.2d 104 (Mo. App. W.D. 1993), the court rebuffed the Division of Family Services's argument that, based on *Tidrow v. Director, Missouri State Division of Family Services*, 688 S.W.2d 9 (Mo. App. E.D. 1985), a spendthrift clause was required in order for the trust assets not to be considered an available resource to the beneficiary. The court said, "The spendthrift clause was significant in *Tidrow* as evidence of the settlor's intent to supplement state aid. It was not a requisite to the result." Nevertheless, every supplemental benefits trust should contain a spendthrift clause.

### 4. Trustee Discretion

A supplemental benefit trust should give the trustee total and unfettered discretion when it comes to making distributions from the trust. Often, this is phrased as "sole and absolute discretion." See Clifton B. Kruse, Jr., *Third Party and Self-created Trusts*, Notes on Use 1, C, p. 92 (2<sup>nd</sup> ed. 1998) (published by the Section of Real Property, Probate and Trust Law of the American Bar Association), for a more complete discussion of phrasing to use when describing a trustee's discretion. Unless a pure discretionary trust distribution standard is being used, the only limitations should be that the settlor prefers distributions be limited to those that are, in the trustee's opinion, for the beneficiary's special needs, or in the beneficiary's best interest.

### 5. Unique Trustee Powers

The trustee of a supplemental benefit trust should be expressly granted some unique powers not typically found in trusts. Among them are:

- a. The power to invest in non income-producing assets, such as housing, motor vehicles, computers, and other items;
- b. The power to either charge the beneficiary rent to use trust assets (such as housing) or to waive any rent; and
- c. The power to establish subtrusts or other legal entities (such as a corporation) to hold certain trust assets (such as a motor vehicle) for liability protection or other purposes deemed appropriate by the trustee.

#### B. Coordinating With Benefits the Beneficiary Is Receiving

It is important to know which public assistance benefits the trust beneficiary is either receiving or for which the beneficiary may be eligible. The basic criteria of the six major public assistance programs a trust beneficiary may be participating in, as they relate to the design of a trust, are discussed below.

The first three programs (Social Security, Medicare, and veterans benefits) are not needs based. All the other major public assistance benefit programs are needs based. In other words, a person does not qualify for the last three programs (SSI, Medicaid, and assisted housing) unless the person meets certain criteria, two of which are low income and minimum assets “available” to the person.

#### 1. Social Security

A trust beneficiary may be receiving Social Security benefits. This may be old-age assistance (retirement benefits), survivor’s benefits, or disability benefits. This program is officially known as Old Age, Survivors, and Disability Insurance. This law is found at 42 U.S.C. §§401, et seq., and 20 C.F.R. pt. 404.

#### 2. Medicare

A trust beneficiary may be participating in the Medicare program. This is a health insurance program that provides for hospitalization, most doctor’s charges, some skilled nursing home care, and some home care. The law is found at Title XVIII of the Social Security Act, which is codified at 42 U.S.C. §§ 1395, et seq., and 42 C.F.R. pts. 405-424. It is administered by the Centers for Medicare and Medicaid Services (CMS, formerly known as the Health Care Financing Administration (HCFA)).

#### 3. Veterans Benefits

A trust beneficiary may be receiving benefits from the Veterans Administration or one of the branches of the United States military. Eligibility to receive such benefits is usually not dependent on the person’s financial condition, but there are exceptions. If a potential trust beneficiary is receiving veterans benefits, the trust drafter should fully understand the impact of a trust on the benefits before designing the trust.

#### 4. Supplemental Security Income

SSI is a federal program administered by the Social Security Administration. The law is found at 42 U.S.C. §§ 1381, et seq., and 20 C.F.R. pt. 416. The Social Security Administration also has an operations manual to guide its caseworkers. It is called the Program Operations Manual System (POMS), available at <http://policy.ssa.gov/poms.nsf/aboutpoms>.

#### 5. Medicaid

Medicaid is a welfare program that is a partnership between the United States federal government and the states. The federal law is found at Title XIX of the Social Security Act, 42 U.S.C. § 1396 and 42 C.F.R. pts. 430, 431, and 435. Each state will also have its own statutes and regulations dealing with its Medicaid program. The Missouri law is found at §§ 208.010, et seq., RSMo 2000 and Supp. 2001, and 13 C.S.R. §§ 40-2.010, et seq. The federal agency administering the Medicaid law is the CMS, formerly known as the HCFA. In Missouri, the Division of Social Services, through the Family

Support Division (FSD), formerly known as the Division of Family Services, administers the Medicaid program. FSD has an operations manual to guide its employees. It is referred to as the Income Maintenance Manual.

## 6. Assisted Housing

An elderly or disabled person may also be participation in any one of a number of assisted housing programs. Most of these are federal programs administered by the Department of Housing and Urban Development. The two primary programs are Section 8 Rental Assistance, 42 U.S.C. § 1437, and the Section 202 Program, 12 U.S.C. §1701q. Other federal assisted housing programs are Section 504 Rural Housing Assistance, Section 502 Rural Mortgage Assistance, and Section 235 Mortgage Assistance. 42 U.S.C. § 9817.

### C. Who Should Be Trustee

Generally, it is better if the trustee of a supplemental benefit trust is an independent nonfamily member. Not only will an independent nonfamily member tend to be more objective, but he or she should not be subject to the continual conflicts of interest that will inevitably arise if close family members serve. In addition, if there is a judge reviewing or approving the trust, the judge may insist that the trustee be independent.

If it is possible to have more than one trustee serving at the same time. If one of them is independent, the other or others can be family members. In this situation, the family member usually is the one to maintain close contact with the beneficiary and monitor the beneficiary's needs. The independent trustee will usually be the one that manages the trust estate.

No matter who serves as trustee, it is recommended that there be some sort of oversight established. This becomes especially important if the trustee is not independent. At a minimum, this oversight should consist of requiring the trustee to provide settlements at least annually. Someone should be given the authority in the trust document to review and question or approve these settlements. Options include the beneficiary's guardian, other family members, an independent person, a committee of people, or a court.

Although it is acceptable, and quite common, for the settlor to serve as trustee of a revocable third-party settled supplemental benefit trust, that is the only time a settlor should consider serving as trustee. For tax and other reasons, the settlor of an irrevocable third-party settled or a self-settled supplemental benefit trust should not be the trustee or have much, if any, authority over the trustee.

The beneficiary should not be the trustee of a supplemental benefit trust, even if he or she has the mental ability to do so. This would usually make the trust assets an available resource for the public assistance benefit programs.

#### D. Removal and Appointment of Trustees

The ability to remove and appoint trustees is an important part of a supplemental benefit trust. Traditionally, the trustee will have “sole and absolute discretion” concerning how to distribute the trust assets. In addition, the trustee will be responsible for prudently investing the trust assets. Someone, or a group of people, should have authority to remove a trustee if it becomes advisable or necessary. In addition, a trustee may resign or become incapable of serving, and the trust should provide the method by which a successor trustee is chosen and empowered.

#### E. Amendment of the Trust

It is recommended that the trustee (or a trust protector) be granted the power to amend the trust to facilitate its administration and to accommodate changes in tax or other laws relating to the trust.

### VI. Third-Party Settled Trusts

#### A. Definition

A third-party settled trust is a trust that is not executed as “settlor” by the beneficiary of the trust and does not contain any assets that belonged to the beneficiary. Whether a third-party settled trust will disqualify the beneficiary from receiving Medicaid or Supplemental Security Income (SSI) benefits depends on the intent of the settlor and the provisions of the trust document.

#### B. Dilemma of a Third Party

A person who wants to give assets of money to someone who has a disability needs to be careful to do so in a way that actually benefits the disabled person. If the person who has a disability is unable to manage his or her finances or is receiving Medicaid or SSI benefits, a gift of the assets directly to the disabled person may have devastating consequences.

Options:

1. Leave the assets outright to the child, in which case the child can either manage them or a conservatorship will need to be established for the child.
2. Leave the assets to another person (a third party) with the unwritten understanding that the third party will use the assets for the benefits of the child (or, in other words, impose a moral obligation on the third party to use assets that will be owned outright by the third party for the benefit of the child).
3. Completely disinherit the child, leaving the child totally dependent on public assistance programs and the charity of others.

4. Leave the assets in a trust for the benefit of the child. The trust can be either a traditional “support trust,” a “discretionary support trust,” a “totally discretionary trust,” or a “special needs trust.” However, to preserve family assets and to avoid the risk the trust assets may be considered available resources which would disqualify the child from receiving governmental benefits, a supplemental benefits trust should be used.

## VII. Self-Settled Trusts

### A. Definition

By far the greatest amount of legislation, litigation, and confusion when dealing with trusts to use for persons who are elderly or disabled is in the area of self-settled trusts. As discussed above, a self-settled trust is one that holds any assets that formerly belonged to the beneficiary of the trust, even if that person did not sign the trust as a settlor.

### B. When to Use a Self-Settled Trust

The need for the use of a self-settled trust, for an elderly or disabled person will typically arise in one of the situations described in below.

#### 1. Personal Injury Award

The need for a self-settled trust may arise when a person who has a disability receives a personal injury award. If the person was so severely disabled that the person cannot effectively manage his or her own assets, the traditional approach was to establish a conservatorship to hold the award and to assure that it was used for the benefit of the disabled person. But conservatorship assets are deemed to be “available” to the conservatee for Medicaid and Supplemental Security Income (SSI) eligibility purposes, so the award would have to be “spent down” before such public assistance would be available. In addition to effectively wasting the award, in many cases this also has the effect of cutting the disabled person off from participating in programs that would be very helpful to the disabled person but that must give first priority to persons eligible for Medicaid.

#### 2. Inheritance and Gifts

Another event that may give rise to the need for a self-settled trust is when a person who has a disability receives an inheritance or gift that is large enough to disqualify the person from Medicaid and SSI. The inheritance or gift can be transferred to a self-settled trust by the disabled person or a representative.

### 3. Accumulated Assets

There are two situations when it may be appropriate to transfer assets accumulated in the name of a disabled person to a self-settled trust.

#### a. Minor Disabled Person

Often, well-meaning parents or other relatives will make gifts to a minor disabled child through the Uniform Transfers to Minors Act (UTMA), (in Missouri, the Missouri Transfers to Minors Law, §§ 404.005-404.094, RSMo 2000), accounts, traditional minor's trusts, outright, or in joint names with the child. Once the child reaches eighteen years of age and would otherwise qualify for Medicaid and SSI, these assets will be deemed to be available to the child and will have to be "spent down" before the child is eligible for Medicaid.

Instead, it may be possible to establish a self-settled supplemental benefit trust and have the custodian or trustee transfer the assets in the UTMA account or the minor's trust to the self-settled supplemental benefit trust.

#### b. Adult Recently Disabled Person

An adult who is not disabled and who has accumulated assets and investments over his or her lifetime may become disabled as a result of an accident or illness. All of the assets that had been accumulated are now "available resources" for Medicaid purposes and will have to be "spent down" to qualify for Medicaid. Depending on the situation, it may be possible to transfer these assets to a self-settled supplemental benefit trust that will not disqualify the recipient from Medicaid and SSI.

### C. Types of Self-Settled Trusts which Permit Medicaid Eligibility

After closing virtually every avenue for creating a self-settled trust that allows the settlor/beneficiary to retain Medicaid eligibility, OBRA '93 excluded three kinds of trusts ("exempt trusts") from the above rules.

Even if a Medicaid applicant is deemed to have established any of these trusts, the principal of these trusts will not count as an available resource and will not disqualify the applicant from receiving Medicaid.

#### 1. d4A Trust (a/k/a Medicaid Payback Trust)

For ease of reference, the term "d4A trust" is used here to describe the trust authorized by 42 U.S.C. §1396p(d)(4)(A) despite the fact that the enabling legislation did not actually name this trust. Various authors have used different names, such as "Disability Trust," "Medicaid Payback Trust," "Supplemental Care Trust," "Special Needs Trust," and "Self-Settled Special Needs Trusts."

a. When to Use a d4A Trust

A d4A trust is designed to be used when a person with disabilities severe enough to meet the definition of disability for Social Security purposes, and who is also under the age of sixty-five years and is otherwise eligible for Medicaid, holds (or is about to receive) assets worth enough to cause the person to be ineligible for Medicaid merely because of the value of the assets.

By transferring the assets to a properly drafted d4A trust, the disabled person can qualify for Medicaid assistance, and the money placed into the d4A trust can be used to supplement public assistance benefits the disabled person is receiving. Otherwise, the money would first have to be “spent down” below \$1,000 before the person would qualify for Medicaid assistance in Missouri.

b. Rules for d4A Trusts

Note: This description is based on both 42 U.S.C. § 1396p(d)(4)(A) and § 3259.7.A of Transmittal No. 64 (State Medicaid Manual, Transmittal No. 64, November 1994, adding §§ 3258 and 3259) promulgated by the Health Care Financing Administration (now known as the Centers for Medicare and Medicaid Services).

- (1) If the applicant is *disabled* sufficiently to qualify for SSI (as defined in 42 U.S.C. §1382c(a)(3)); and
- (2) The applicant is under the age of sixty-five years at the time the trust is established and funded; and
- (3) The trust is established for the benefit of the applicant; and
- (4) The trust is established by the applicant’s parent, grandparent, legal guardian, or a court (note that the applicant cannot establish this trust and it cannot be established by the applicant’s spouse, child, or attorney-in-fact); and
- (5) At the death of the applicant, any assets remaining in the trust will repay the state (or states) up to what is spent on the applicant for Medicaid assistance (any excess after Medicaid is repaid can be distributed however the settlor stated in the trust document); then
- (6) Transfer of the applicant’s assets to the trust will not create a transfer penalty; and
- (7) The trust assets will not be deemed unavailable resource; and
- (8) The applicant will qualify for Medicaid (assuming he or she otherwise qualifies); and

(9) Distributions from the trust to the applicant can be used for the benefit of the applicant (presumably to supplement the applicant's Medicaid benefits); and

(10) Although the trust can continue to provide supplemental assistance to the applicant after he or she attains the age of sixty-five years (assuming it was established before that time), no additional contributions can be made to the trust after the applicant is sixty-five years old.

2. Qualified Income Trust (Miller Trust)  
(42 U.S.C. § 1396p(d)(4)(B))

This trust only applies to Medicaid applicants residing in an income cap state. Because Missouri is not an income cap state, a description of this trust is omitted.

3. Pooled Trust (42 U.S.C. § 1396p(d)(4)(c))

- a. If the applicant is disabled sufficiently to qualify for SSI; and
- b. A nonprofit association establishes and manages a trust;
- c. That allows a separate account within the trust to be established for the benefit of the applicant by either the applicant; the applicant's parent, grandparent, or legal guardian; or by a court; and
- d. The trust keeps the accounts for all beneficiaries of the trust separate from each other, but the principal can be pooled for investments purposes; and
- e. The separate account is solely for the benefit of the disabled applicant for whom the account was established; then
- f. The trust may distribute to the applicant to supplement the applicant's Medicaid without disqualifying the applicant from receiving Medicaid; and
- g. When the applicant dies, the grantor charity may keep some or all of the assets remaining in the applicant's separate account. This must be used for charitable purposes. Whatever is not kept by the charity must be used to repay the Medicaid program for all amounts it paid on behalf of the applicant.
- h. When to Consider Using a Pooled Trust: There may be times, such as those listed below, when it might be better or necessary to use a pooled trust rather than a d4A trust:

(1) When the disabled person is age sixty-five or older (although transfers to a pooled trust for a person sixty-five or older will most likely generate a Medicaid transfer penalty)

(2) When there is no person or financial institution appropriate or willing to act as trustee; this may occur because there is not an appropriate person and the amount of the trust estate is too small to interest a corporate trustee

(3) When there is no parent or grandparent willing or able to establish the trust, and for some reason it is not appropriate or feasible to go to court to accomplish this; with a pooled trust, the disabled person can establish the separate account under the pooled trust

(4) When the cost of establishing the d4A trust is excessive in light of the amount to be transferred to the trust

i. Some of the disadvantages of using a pooled trust are listed below:

(1) The choice of trustee is made solely by the nonprofit association. The nonprofit association can either serve as trustee or choose a financial institution (or possibly a person) to do so. Neither the disabled beneficiary nor any family member or advisor has authority to appoint a trustee of their choice.

(2) If the trustee is not doing a good job or is not responding to the beneficiary's needs, there is usually not a way to remove the trustee and replace it with a more responsive trustee. It may be possible to go to court and request this action, but because that would most likely affect all of the other beneficiaries or other accounts being held in a pool, it would be a challenging, and probably expensive, litigation.

(3) Because the nonprofit association is the beneficiary of the remainder of the pooled account upon the death of the beneficiary, there may be conflict of interest that is unacceptable to the beneficiary.

(4) None of the pooled accounts will be paid to the family members or others of the beneficiary's choice, even if it exceeds the amount that would have been paid back to the state for Medicaid assistance.

## VIII. Tax Issues

### A. Tax Issues—Design and Drafting Suggestions for d4A Trusts

The drafter of a self-settled supplemental benefit trust must take into account the effect of income, gift, and estate taxes when designing the trust. Failure to do so may result in a devastating impact on the trust assets. The discussion below is solely focused on the OBRA '93 d4A trust.

## 1. Income Taxes

### a. Personal Injury Awards

Damages received because of personal injury or sickness are not included in Recipient's gross taxable income, whether received in lump sum or in the Form of periodic payments that include investment interest. I.R.C. § 104(a)(2). The law concerning punitive damages is less settled.

### b. Taxation of Trust Income

Generally irrevocable trusts are taxed as a separate taxpayer. The trust will have its own tax identification number, and the trustee will file an annual fiduciary income tax return (Form 1041). Income distributed to the beneficiary will be taxed to the beneficiary, and income accumulated in the trust will be taxed to the trust.

### c. Grantor Trusts

#### (1) Generally

In order for accumulated trust income to be taxed at the beneficiary's lower income tax bracket rather than the trust's higher bracket, the trust must be a "grantor trust." This is a trust where the grantor has retained a certain amount of control or interest in the trust sufficient to meet the criteria of I.R.C. §§ 671-77.

#### (2) Methods of Making the d4A trust a "Grantor Trust"

Merely incorporating into the trust any of the powers and rights listed in I.R.C. §§ 671-77 will make the trust a grantor trust for income tax purposes. But when drafting a d4A trust, care must be taken when selecting which of these powers and rights to use because many of them will cause the trust to be an available resource for public assistance benefit purposes. If the wrong provisions are used, the beneficiary will be disqualified from participating in these programs.

## 2. Gift Taxes

If the transfer from beneficiary to a d4A trust is deemed to be a completed gift, there will be gift taxes due upon the transfer. This is something to be avoided if at all possible.

The drafter of a d4A trust should consider giving the beneficiary a testamentary power of appointment over the remainder of the trust after Medicaid is repaid after repayment of any creditor that provided care, maintenance, or support to the beneficiary in order to comply with §

475.092, RSMo 2000). This will ensure that the transfer is not a completed gift. For guidance, see Treas. Reg. § 25.2511-2(c) and Priv. Ltr. Rul. 94-37-034 (June 20, 1994).

### 3. Estate Taxes

If the d4A trust is designed as described above to make the trust income taxable to the beneficiary and to avoid the gift tax upon the funding of the trust, most likely the fair market value of the trust assets at the beneficiary's death will be included in the beneficiary's taxable estate.

But the claim of the state for reimbursement of Medicaid payments made on behalf of the beneficiary, along with other debts and administrative expenses, will reduce the gross estate for tax purposes. I.R.C. § 2053

### B. Tax Issues for Third Party Supplemental Benefit Trusts

#### 1. Grantor vs. Non-Grantor Trust Status

The most common use of the Third Party Supplemental Benefits Trust involves a testamentary trust. This trust can be drafted to be taxed under the Grantor Trust rules, in which case the tax identification number of the beneficiary serves as the tax identification number of the trust, and a fiduciary income tax return (IRS form 1041) is not required to be filed. Income to the trust is reported on the beneficiary's individual 1040. "Income" for income tax purposes is quite different than "income" for government benefit purposes. The Trustee should be prepared to carefully account for the use of trust income to demonstrate it was not used in a manner which could disqualify the beneficiary from receiving governmental benefits.

#### 2. Use of the Inter-vivos Third Party Supplemental Benefits Trust

This technique is not in great demand with the exemption equivalent amount for the federal estate tax at \$2,000,000 and likely to increase in the future. But for those clients who have taxable estates, funding an Irrevocable Inter-vivos Third Party Supplemental Benefits Trust could produce gift and estate tax savings. Transfers of the annual exclusion amount of \$12,000 per donor to an unlimited number of beneficiaries could minimize or eliminate estate tax liability. The gifts could be used to purchase life insurance on one or both parents which would result in substantial leveraging of the gifts. Note, however, that the *Crummey* withdrawal power should not be given to the disabled child since this would disqualify the child from receiving governmental benefits. It is advisable to have beneficiaries other than the disabled child included in the trust who would be granted the withdrawal power, so that transfers to the trust would be treated as gifts of a present interest and therefore qualified as annual exclusion gifts.

## IX. Administration of Supplemental Benefit Trusts

A. Administration of an SNT must be handled on a case by case basis. Each case varies depending upon the approach of the supervising agencies (i.e. probate court, state Attorney General) and the specific and changing needs of the individual beneficiary. In addition, state variations in entitlement programs and developing case law create a fantastic maze of what has been called potential predicaments, dilemmas, and quandaries in administration for the trustee. The most important issue is defining what is a “special need” and what is “basic support.”

1. “Special needs” SNT distributions (under most state and federal programs) which WILL NOT result in disqualification to receive government benefits:

- a. Purchase of a residence;
- b. Private school tuition (especially special education);
- c. Health and life insurance premiums;
- d. Entertainment and recreation (movies, plays, sporting events, hobbies);
- e. Vacation travel (but technically, perhaps not lodging or food);
- f. Transportation;
- g. Household goods;
- h. Telephone, including cell phone;
- i. Medical costs—if not covered by other benefit programs, including personal care services (e.g., home health aides);
- j. Income taxes, trustee fees, attorney fees, trust administration costs;

2. “Basic support” SNT distributions (under most state and federal programs) which WILL result in disqualification to receive government benefits:

- a. Rent;
- b. Utilities;
- c. Food;
- d. Clothing;

- e. Medical expenses which are covered by a benefit program;
- f. Cash distributed to beneficiaries (cash payments should be to third parties for payment of appropriate services and goods);

B. Other SNT administration issues that require attention include:

- 1. Amending SNT to comply with new state law(s) protecting the trust;
- 2. Amending SNT to correct drafting errors;
- 3. Arguments with state agencies regarding “availability” of trust assets;
- 4. Attacks on extent of trustee’s “sole, absolute and uncontrolled” discretion to refuse to provide basic support for the beneficiary.

C. The Role of The Attorney For The Trust

1. If the attorney is not going to serve as a trustee of the SNT, then the attorney’s role is to counsel and educate the fiduciaries. This includes what it means to be a fiduciary, the reporting requirements to various agencies, budgeting trust assets for the needs of the beneficiary, et cetera.

2. If the attorney is to play a direct continuing role in the administration of the SNT, then the education process noted above is still crucial. However, the attorney will also need to schedule periodic meetings to review the assets, income, and disbursements of the trust and confirm that all accounting and tax reporting duties are fulfilled on a continuing basis.

D. The Role Of The Trustee

1. Who can serve as Trustee? The short answer: any qualified person or entity who is willing to take the responsibility of holding the legal title to the property of another can serve as trustee. The long answer: someone who will take the time to digest the myriad of government entitlement programs and make the appropriate applications and properly manage the trust. In addition, the trustee must be someone who will take the time to understand the current and future special needs of the beneficiary.

2. Duties And Obligations Of The Trustee. Generally speaking, a trustee always has a duty to act reasonably. A useful explanation of the duties of an SNT trustee (despite the state-specific nature of the text), can be found in Barbara D. Jackins et al., *Special Needs Trust Administration Manual: A Guide For Trustees* (2005). The authors specifically note the following (which is a summary of general fiduciary obligations):

a. **Duty To Be Generally Prudent.** Many states have adopted a prudent Investor Act. Essentially, the trustee must act in a reasonable manner in light of the circumstances presented to the trustee.

b. **Duty To Carry Out The Terms Of The Trust.** The trustee must read the trust document and carry out the intentions of the Grantor/Settlor expressed therein.

c. **Duty To Be Loyal To The Trust.** A trustee must not allow his or her interests to compete with the trust's and/or the beneficiaries' interest.

d. **Duty To Give Personal Attention To The Affairs Of The Trust.** The appointment as trustee is a personal appointment and, as such, the overall responsibility to the trust's management cannot be delegated. (This does not mean that the trustee cannot seek the help and advice of the appropriate professionals.)

e. **Duty To Account To The Beneficiary.** A summary of the trust activities—income, distributions, etc.—should be prepared by the trustee regularly, usually annually, and never less frequently than triennially. The beneficiary, or a representative charged with determining the beneficiary's best interest, should review the accounting.

f. **Duty To Make Trust Property Productive.** Trust assets must be invested to produce a reasonable flow of income and a reasonable rate of return.

3. **Trustee's Discretion.** The SNT trustee must have extremely broad ("sole, absolute and uncontrolled") discretion, but the trustee must understand the implications of any distributions from the trust so as to not jeopardize government entitlements.

4. **Trustee Fees.** SNT trustees are entitled to reasonable compensation for their services unless otherwise provided by law or by the trust agreement.

5. **Resignation, Removal, Succession Of Trustee.** Most properly drafted SNTs will include provisions governing the resignation of a trustee, the need to remove a trustee, or a method to choose a successor trustee. If a court is overseeing the trust, court approval may be required. Outgoing trustees will certainly have to file an accounting. If a court is not overseeing the trust, then the resigning trustee must give notice to the beneficiary or follow the other procedures of the trust agreement and continue his or her fiduciary role until a successor trustee takes possession.

6. **Trust Termination.** In most cases, the death of the lifetime beneficiary will cause the SNT to end and require the final distribution of trust assets to the remainder beneficiaries. The trustee must pay the final expenses authorized by the trust, prepare a final accounting, and distribute the remaining assets before the trust is terminated.

## X. How the Missouri Family Trust Compares to d4A Trusts

The Missouri family trust was established by the Missouri legislature in 1989. The law is located at §§ 402.199, *et seq.*, RSMo 2000, and 21 C.S.R Division 10. When it was enacted, it was a giant step forward for persons who were disabled. But since the advent of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (OBRA '93), trust, the applicability of the Missouri family trust is limited.

Although it is easier and less expensive to establish than a d4A trust, the Missouri family trust is often more bureaucratic and inflexible in its administration. Despite this, however, the Missouri family trust should be considered as an option, especially if a d4A trust will not work in a particular situation.

## XI. Philanthropy And Special Needs Trusts

The IRS has approved charitable remainder trusts that pay income to a legally incompetent child for life, but with the payments going to a special needs trust established for the child (Rev. Rul. 2002-20).

The IRS has indicated that such arrangements are appropriate where the income beneficiary by reason of a medically determinable physical or mental impairment, is unable to manage his or her own financial affairs. The trustee of the special needs trust could have broad discretion as to how much income or principal would be paid to the beneficiary, and could take into account government benefits to which the beneficiary may be entitled.

Assets in the charitable remainder special needs trust could pass at the beneficiary's death to one or more qualified charitable beneficiaries.

## APPENDIX A

### Brief Review Of Government Entitlements Available To Persons With Special Needs

An understanding of which benefits are or may be received by an individual is critical to the proper planning for a disabled family member.

#### 1. *Cash Assistance*

- a. Social Security Disability. Title II of the Social Security Act, 42 U.S.C. §401 et seq.; 20 C.F.R. Part 404. “SSD” is an “insurance” program, not a “welfare” program. There are no income or asset limits. The essential criterion is the individual’s inability to engage in gainful employment. 42 U.S.C. §§416(i)-(1), 423(d)(1)(A), 423(d)(2)(A); 20 C.F.R. §404.1501-404.1599. However, a disabled person who was not himself or herself a worker can only receive benefits if he or she is the child or spouse of a deceased, disabled, or retired worker. 42 U.S.C. §402(d); 20 C.F.R. §404.350
  - i. The SSD benefit depends on the worker’s past earnings record. In 2006, the maximum (full retirement) benefit is \$2,053/month; 50 percent of that amount for the eligible spouse, minor, or disabled child of a retired or disabled worker; and up to 75 percent of that amount for the eligible spouse, minor, or disabled child of a deceased worker.
  - ii. In 2006, an individual may earn approximately \$860/month (if blind \$1,450/month) without losing SSD. However, the eligibility rules are technical. See 20 C.F.R. §404.1592
  - iii. Unlike most other government programs, the receipt of a personal injury award or an inheritance does not normally affect SSD eligibility.
- b. *Federal “Supplemental Security Income” (“SSI”)*. Title XVI of the Social Security Act, 42 U.S.C. §1381 et seq.; 20 C.F.R. Part 416. Unlike SSD, SSI is a welfare program. The benefit maximum in 2006 for an individual is \$603/month and one-third less for a minor living with another person or living at home or for others living and sharing cooking facilities with another person. The maximum benefit in 2006 for a couple is \$904/month.
  - i. *Income Limits For Eligibility*
    - (1) In general, income offsets SSI dollar for dollar. “Income” includes cash (including inheritances and gifts over \$20 per month” and in-kind assistance for food or shelter (normally imputed to be one-third the total benefits in a family context). 42 U.S.C. §1382a(a)(2),(b)(3)(A).

- (2) The first 65\$/month of earned income, and one-half of all additional earned income, is “disregarded,” i.e., is not counted as income. Additional amounts earned pursuant to an “approved self-support plan” may also be disregarded.
  - (3) Income received by a trust for the benefit of an SSI recipient may be counted unless the trust prohibits, or makes completely discretionary, its use for “food and shelter.”
- ii. *Asset Limits For Eligibility.* Currently these limits are \$2,000 for an individual and \$3,000 for a couple living in the community. Not counted: a home, a car, a burial plot, and an irrevocable funeral contract. 42 U.S.C. §1382b(a), 20 C.F.R. §416.12212 et seq.
  - iii. *Effect Of Transfers On Eligibility:* See 42 U.S.C. §1382b; 20 C.F.R. §416.1246. Transfer penalties (similar but not identical to those applicable to institutionalized Medicaid benefits) apply.
- c. *State Programs*
- i. *State “Cash Assistance” Or “State Supplements Assistance” Or “Aid To The Aged, Blind, And Disabled.”* Social Security Act, Title XVI (42 U.S.C. §1382e et seq.). There are often state welfare programs in place to provide supplemental assistance to individuals receiving federal SSI benefits or who would receive SSI but for their SSD benefit.
  - ii. *Property Tax Relief.* Many municipalities provide some property tax relief to elderly and /or disabled homeowners.
  - iii. *Subsidized Housing.* An important source of decent, safe, and affordable housing for low income individuals with disabilities is subsidized housing. Usually federal funded and administered by the Department of Housing and Urban Development, these programs are managed by the state and local housing authorities. Tenants pay a percentage of their income (typically, 30 percent) and the housing authority pays the balance directly to the landlord.
  - iv. *Food Stamps.* This federally funded program enables low-income persons to buy food and other necessities. Benefits are, in most states, issued electronically to the food stamp recipient’s card each month. The recipient uses the card at local grocery stores—much like a debit card. For most low-income households, food stamps are only part of their food budget.
  - v. *Department Of Mental Retardation (“DMR”) Funding.* In some states DMR or similar agencies provide core management and other services to qualified individuals. Before

2005, there were no income or asset tests for eligibility for such services. Recipients now must generally qualify for SSI or receive a personal waiver.

2. *Medical Assistance*

- a. *Medicare*. Title XVIII of the Social Security Act; 42 U.S.C. §1395 et seq.; 42 C.F.R. Part 400. The Medicare program provides federally funded insurance subject to deductibles and co-payments. In 2006, “Part B” coverage requires payment of an \$88.50 premium per month. Medicare is available to disabled individuals after 24 months of receipt of SSD benefits. 42 U.S.C. §426(b) (Title II). Unfortunately, often only inferior “Medigap” or Medicare supplemental health insurance policies are available to disabled individuals (until age 65, when there is a brief opportunity to purchase coverage without regard to medical condition or disability). The “Qualified Medicare Beneficiary” program helps needy individuals with income in excess of Medicaid limits to pay Part B Premiums and, in some cases, deductibles.
- b. *Medicaid*. Title XIX of the Social Security Act; 42 U.S.C. §1396 et seq. Medicaid is an extremely important health insurance program that provides medical benefits to the disabled, as well as to low- and middle-income individuals and their families. The eligibility rules and coverage types differ, depending on one’s age (65 and older, or under 65) and where the recipient is living (in an institution, or in the community).
  - i. Medicaid is a federally funded, but state-run, program intended to provide medical assistance to those unable to pay. Within the broad federal guidelines, each of the states establishes its own eligibility standards. The states have great latitude to determine the type, amount, duration, and scope of service; and generally administer the program in other respects. As a result, Medicaid varies significantly from state to state.
  - ii. The Medicaid program is said to grow on “auto-pilot” and there is much controversy as to whether this growth can be sustained. After a Congressional budget resolution for fiscal year 2006 had instructed several committees in both the House of Representatives and the Senate to recommend legislative changes that would reduce outlays from direct spending, the Congress passed the Deficit Reduction Act of 2005 (“DRA”). DRA is the first major effort to restrict growth in these federal benefits in eight years and the changes are drastic. The effective date in most states is still unclear. (A more detailed explanation of the DRA changes can be found in the outlines that accompanied this one in February 2006 ALI-ABA course materials *Elder Law: Issues, Answers, and Opportunities*. Those course materials may be found at <https://d2d.aliaba.org/index.cfm?fuseaction=displayCoursebooksBySubject&coursebook=928&NAV-MODE=coursebooks&NAVSUBMODE==928>.)
- c. *State Programs*. States often offer prescription drug programs for elderly and certain disabled individuals. There is usually some contribution required—i.e. co-payment, deductible, monthly premium.

**APPENDIX B**

**SPECIAL NEEDS TRUST COMPARISON**

<i>Issue</i>	<i>Third Party SNT</i>	<i>Self-Settled SNT</i>
Settlor	Third Party	Parent, Grandparent, Guardian, or Court
Funded by Assets of	Third Party	Disabled Person
Beneficiary	Disabled Person and Nondisabled Person	Disabled Person Only
Settlor 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 Be	Cannot Use
Estate Tax	Can Be Excluded	Includable
Distributions	Payments to Third Party	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

## **APPENDIX C**

### **Technical Corrections to the Missouri Uniform Trust Code HCS SS SCS SB 892 – Financial Institutions and Missouri Uniform Trust Code Signed 7/10/06**

Methods for creating trust amended to include judicial creation of Medicaid payback trusts. § 456.4-401 RSMo.

Requirements for creating trust to exclude properly created Medicaid payback trusts. § 456.4-402 RSMo.

Prevents special needs trust from being subject to termination on agreement of settlor and beneficiaries. § 456.4-411A RSMo.

Protects discretionary interests in trust from creditors. § 456.5-504 RSMo.

Matches provisions on court created special needs trust to Medicaid/SS requirements. § 475.092 RSMo.

Abolishes Doctrine of Worthier Title to prevent inadvertent disqualification of special needs trust. § 469.500 RSMo.

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For information regarding The Academy of Special Needs Planners, go to [www.specialneedsplanners.com](http://www.specialneedsplanners.com).