§SPECIAL NEEDS TRUSTS

- Special Needs Trust (SNT): type of trust designed to protect a beneficiary who is disabled, enabling them to receive governmental benefits:

  - Supplemental Security Income-automatically comes with Medicaid
  - Medicaid
  - Social Security Disability-Medicare
  - Special Education services

- Special Needs Trust is a term commonly used to describe trust funds created to supplement benefits for disabled individuals not provided through government entitlements. Similarly, supplemental needs, luxury trusts, and amenities trusts are terms often used to describe such trusts.

- A SNT will usually be drafted that will neither subject the government benefits recipient to any period of ineligibility nor reduce the benefits that the programs provide. There may be times however, a beneficiary's level of government benefits can reasonably be reduced, so long as essential elements of those benefits are not eliminated. For example when an SSI beneficiary suffers reduced monthly SSI benefits but retains fully Medicaid coverage for medical needs.

- <u>THREE BASICS SNTs</u>

There are three basic types of special needs trusts ("SNT"):

1. The (d)(4)(a) and (c)(2)(B) Trusts

First, 42 U.S.C. 1396p(d)(4) sets out criteria to create a self-settled trust for a disabled individual that will exclude the trust's assets or income for government benefits eligibility purposes. Three SNT's are set out in 1396p(d)(4). The 1396p(d)(4)(a) trust can be established for assets of an individual under age 65. The (d)(4)(a) trust must be established by a parent, grandparent, legal guardian, or a court and the state must be named to receive all amounts remaining in the trust upon the death of the beneficiary up to the total state medical assistance benefits paid on behalf of the individual. The (d)(4)(b) trust is an income only trust that does not apply in states like North Carolina that are not income cap states. The (d)(4)(c) trust, a pooled trust, can be established for assets of an individual over age 65. The (d)(4)(c) trust is established and managed by a non-profit organization. The trust must contain provisions to reimburse Medicaid or be retained by the non-profit upon the death of the beneficiary.

2. 3rd Party Trust

A third party SNT is sometimes distinguished from the (d)(4) trusts by being referred to as a Supplemental Needs Trust. Third Party SNT's are established by and use funds belonging to a person other than the disabled beneficiary. The trust must be discretionary, cannot contain support provisions and is not subject to the payback provisions discussed above.

3. Testamentary Trust

Assets owned by a testamentary SNT, a trust is created <u>under a will</u>, are expressly excluded as assets belonging to a beneficiary under 1396(d)(2)(a). According to federal statute only trusts established under a will, not in a revocable trust, are excluded under this provision and are not subject to the payback provisions discussed above. **North Carolina Medicaid has not distinguished between an irrevocable trust established with someone else's assets and a testamentary trust..**

- The definition of “trust” provided by OBRA 93 specifically excludes testamentary trusts and trusts established by a person other than the beneficiary or spouse, as long as the person is not acting with legal authority or under the direction of the beneficiary or spouse. As under prior law, trust must not contain language that in any way obligates the trustee to use funds for the support of the beneficiary.

- If the beneficiary has no access to the trust property and cannot compel a distribution, then the trust will not be considered as an available resources for determining SSI eligibility.

- Eligibility for SSI & Medicaid benefits requires limited available resources and limited income

- SSI is a federally administered program of monetary aid for certain elderly, blind or disabled persons, incomes are less than the federal benefit rate, total countable resources are worth no more than $2,000 for individuals and $3,000 for couples, keeping the beneficiary eligible for SSI in NC ensures eligibility for Medicaid. Problems arise when SSI is lost due to excess income or resources.

- Working knowledge of benefit eligibility programs and operating rules is essential for drafting SNT's

- 42 USCS _ 1382c (a)(3)
  - An individual shall be considered to be disabled for purposes of this title 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

- Trust must have NO mandatory distributions for health, education, support or maintenance, distributions must be fully discretionary, or restricted

- Trustee can be authorized to distribute only for extra and supplemental items, (for those items or services the beneficiary does not receive from governmental benefits)

- Special needs are those that supplement or enhance, and are above and beyond the basic needs of food and shelter

- If the beneficiary has no legal right to compel distributions from the trust, he/she has no "ascertainable interest" in the trust, and it is not considered "available" for determining eligibility for needs-based governmental benefits

- Useful where the amount of funds available for the individual are not sufficient to provide for all future needs, as in the case of most lawsuits settled by compromise between the parties

- SNT acts as a receptacle to hold proceeds from a lawsuit settlement, insurance or direct inheritance

- Feds allow states to request waivers so that State Medicaid Plans can use funds for a wider choice of services or supports-often targeted to specific populations; least restrictive environment–alternatives to institutional care as mandated by the U.S. Supreme Court in the Olmstead decision. <u>OLMSTEAD vs. L.C.</u>, 138 F. 3d 893 (1999)-Justices recognized the right of individuals with disabilities to live in the least restrictive environment, with the state making reasonable accommodations to achieve integration in the community

- Ability to coordinate both public benefits and private resources; carefully designated SNT can help ensure security for the lifetime of an individual with a disability

- Third Party Special Needs Trust-furnished or gifted by Third Person

- Irrevocable
- Testamentary
- Revocable

■ 42 U.S.C. _1396(d)(4)(A) Trust: Established by parent, grandparent, guardian or court for benefit of an individual who is disabled and under age 65, also known as a "Disability-Pay Back" Trust. Most Self-Created SNT's arise from receipt of proceeds from a lawsuit, insurance, unplanned inheritance that is to be paid to an individual with a disability, funded with a beneficiary's own funds with provisions to reimburse Medicaid for benefits paid upon the beneficiary's demise

■ 42 U.S.C. _1396 (d)(4)(B): an Income-Only Trust from income payable to the person with a disability

■ 42 U.S.C. _1396(d)(4)C, a Pooled Account Trust for an individual with disabilities, established and managed by a non-profit organization, with provisions to reimburse the State for Medicaid benefits and/or retain funds for other like beneficiaries upon the participant's demise.

■ <u>ISSUES IN DRAFTING SPECIAL NEEDS TRUSTS</u>

■ **Identify the Client**

- Family member or friend of an individual with a disability
- Person with a disability or his/her Guardian
- Other, trial attorney, court appointed fiduciary

■ **Beneficiary**

- Current circumstances
- Benefits receiving now
- Eligible for any other benefits
- Court Involvement
- Goals and future expectations
- Annual evaluations

■ **Selection of a suitable Trustee**

- Special needs trusts require more unplanned distributions and greater interaction with the beneficiary than most other trusts, trustee needs to communicate with the beneficiary, family member, professional care providers and state or federal agencies

- Any person with a legal obligation of support to the beneficiary, such as a parent of a minor child or a spouse, should also not be designated trustee unless their power to make distributions is limited to distributions with would not be deemed for support of the beneficiary
- Many beneficiaries are unable to communicate with the trustee or have difficultly
- Regularly and reliably exercise good judgment
- Willing and able to assume responsibilities and to delegate to competent professionals needed to administer the trust
- Can qualify for bond
- Can advocate for Beneficiary
- Understands a Conflict of Interest
- Preclude beneficiary from serving as a Trustee
- Consider inclusion of powers to remove Trustee by beneficiary or designee, with criteria for removal and selection of successor
- Specify whether co-trustees must act unanimously or by majority
- Court supervision, what if the beneficiary moves out of that jurisdiction?
- Reflect requirements of local court in Court Order-not in trust agreement
- Authority for change of trust terms-limited to reflect changes in the law and/or regulations affecting the beneficiary
- Authority to pay beneficiary's tax liability directly to tax authority
- Parent or family member, serving together with an independent or Corporate Co-Trustee

Due to the complexity of an SNT the trustee has heightened responsibilities, including a need to understand or seek and follow professional advice on the complexities of public benefit laws. Beyond a general fiduciary duty to the beneficiary, trustees of an SNT have the following additional duties:

1. An understanding of public benefits laws such as SSI, Medicaid, Medicaid waiver programs, Work First, Section 8 subsidized housing, Medicare. If the trustee does not have sufficient knowledge in these areas professional advice may be necessary.
2. The trustee must make irregular and specific distributions to purchase items or services for the beneficiary instead of regular cash distributions. (These expenditures are subject to the Guidelines established by the Social Security Administration for beneficiaries receiving SSI benefits.

3. The trustee must regularly check on the beneficiary to assess the needs of the beneficiary and to see that the distributions are being used for the beneficiary. This can be particularly time consuming for the trustee if the beneficiary is unable or has difficulty communicating with the trustee.
4. The trustee must apply for and obtain any public benefits to which the beneficiary would be entitled.
5. Once the trustee has obtained public benefits for the beneficiary the trustee is responsible for reporting distributions made from the trust that may impact public benefits.
6. The trustee must keep an accounting of all income and disbursements.
7. The trustee must generally report all income, deductions and credits of the trust for inclusion in the tax return for the beneficiary.
8. The trustee must establish a sound and protective investment strategy according to North Carolina's Prudent Investor Act, N.C.G.S. §36C-9-901. Unlike other trusts, the trustee may need to keep some funds available to deal with a large medical or any other large unexpected expense.
9. The trustee may need to use the assets to purchase a home for the benefit of the beneficiary. If the trustee purchases a home they will need to deal with issues like obtaining home insurance, whether to charge rent for family caregivers that live in the home with the beneficiary. Further, the trustee must then oversee all maintenance and remodeling of the home.
10. If the beneficiary is receiving SSI benefits the trustee cannot spend trust money on food, shelter and cash for the beneficiary. Food and shelter expenses include:
    a. Food;
    b. Mortgage (including property insurance if required by mortgage holder);
    c. Real property taxes;
    d. Rent;

    e. Heating fuel;
    f. Gas;
    g. Electricity;
    h. Water Sewer; and
    i. Garbage removal.

11. The trustee can spend money to pay for activities (e.g. football tickets, Disney World), medical expenses, vocational expenses, educational expenses, and other personal services not covered by any other government benefit. The trustee can also purchase a home, vehicle, pre-need burial policy (trust funds for a payback trust will not be available to pay for a funeral after the beneficiary's death), personal items, and administrative expenses.

12. The trustee will be responsible for handling the trust after the death of the beneficiary. After the death of the beneficiary the trustee must reimburse the state if the trust is a (d)(4)(a) trust or turn over the remaining money to a non-profit and/or the state if the trust is a (d)(4)(c) trust. Prior to disbursing to the non-profit or the state the trustee may only pay taxes due from the trust because of the death and reasonable fees for wrapping up the administration of the trust.

■ **Alternatives to a Corporate Co-Trustee**

· Knowledgeable, advocacy non-profit agency
· Public Administrator/Court appointed Guardian

■ **Surety Bond**

· Serves as a balance to the Trustee’s discretionary powers, exercised without prior Court approval
· Obtained in an amount equal to the trust assets
· Premiums payable annually, deductible as an administrative expense
· Surety is an interested party in any court proceedings involving the trust

■ **Alternatives to Bond**

· Joint control with attorney or bonding company, Court approved annual budget
· Advance court approval for expend funds

- Surety filed, consensual lien in real estate owned by the individual fiduciary

■ **Annual Accountings**
- May or may not be required to be filed by the Court
- Trustee may request Court approval, especially if the trust accounting is unusual or the trust acquires and maintains residential real estate

■ Third party SNT will have remainder beneficiaries, contingent beneficiaries who may be entitled to receive information about the trust administration ab initio

■ Under 65 Disability payback trust may have remainder beneficiaries

■ Whether the beneficiary should have a power to appoint the property remaining after the payback is made, and exercise the right if competent and disability is primarily physical

■ Does the beneficiary have any existing Creditors? Avert fraudulent conveyance claims

■ An independent individual as the "Trust Protector" can be authorized with any or all of the powers below:

- Review annual trust accountings
- Replace an existing Trustee
- Review the actions of the Trustees
- Facilitate the resolution of conflicts between trustees or parties with an interest in the trust
- Approve or recommend Court approval of transactions
- Consent to any amendment to the Trust
- Designate a successor Trust Protector

■ **Distribution standards**

■ *Special Needs Only*
- Distributions for Extra and Supplemental Needs
- Suitable when SSI & Medicaid benefits are essential
- Whether Trustee shall or may share accounting with any court appointed Guardian for the beneficiary

■ "Income" for tax purposes is defined differently than "income" for SSI and Medicaid purposes. SSA defines income as anything an individual receives in cash or in-kind that can be used to meet his food, or shelter

■ Self-settled Special Needs Trusts are drafted as "irrevocable"

- Nothing in the definition of “irrevocable” prevents an “irrevocable document from being amended or modified

- A SNT established by a third party for the benefit of a disabled beneficiary and funded with the settlor’s assets (not the disabled beneficiary’s) could be created as a garden variety, revocable inter vivos trust, not subject to any of the rules covering self-settled SNTs

- Granting modification power to the trustee if confident in the ability of the trustee to act in an appropriate manner. Either professionals or persons or entities independent and neutral to the beneficiary, if the trustee (or any of them) is a person who may potentially, be adverse to the beneficiary, problems can arise. It is with that question in mind, some drafters utilize, trust protector

- Trust can provide that where such a conflict arises, any powers held by the trustee automatically default to the trust protector.

- Broader grant of authority may be appropriate where young child whose ultimate prognosis is unknown, may want to authorize the trustee to liberalize the distribution provisions to take into account improvements in the beneficiary’s condition, not to create too much flexibility which might lead to an attack on the trust as being available to the beneficiary by virtue of the trustee’s authority

- In a third-party SNT, corpus remaining on the death of the primary beneficiary can be distributed in any manner the settlor desires, no different than any other trust

- On Failure of Purpose: Two situations where the purpose may cease to be relevant:

    - If the need for public benefits ceases to exist because the beneficiary no longer requires public benefit;
    - The public benefits themselves no longer exits

- SNT frequently include clauses such as this: in the event that the Trustee’s discretionary right to invade Trust principal has the effect of rendering the Beneficiary ineligible for, Trustee is authorized to terminate this Trust. Probably does not work in connection with self-settled trusts; not creditor protection devices, assets of the trust will be exposed to the debts of the settlor/beneficiary

- Obligation to report distributions which may impact public benefits to the proper agencies

- SSA imputes income where the SSI recipient receives indirect assistance in paying for food or shelter expenses (In-Kind Support and Maintenance (ISM))

- SSA deems a portion of the parents' income available to SSI recipients under age 18, depends on the number of parents, of other children, whether income is earned or unearned

- Once a child attains 18 years of age, compensation of parents as caregivers will have no impact on the adult child's SSI eligibility. Trustees of Payback SNT's should ensure that compensation paid to parents is allowed under the terms of the trust, reasonable based on the care provided

- SNT's are permitted to purchase a home for the beneficiary if suitable accommodation cannot be provided by public assistance programs.

- Ownership of real estate by an SNT can create problems. Insurance and conventional mortgage financing are difficult to obtain where the trust is the owner of the home.

- Parents of the beneficiary often will live in the house, how much rent should they pay to the SNT.

- Have the judge approving a settlement for a special needs child approve of the purchase of the home and the ownership arrangement.

- NC law does not require payback of Medicaid benefits paid to an individual unless the payments were made when the individuals was over 65 years old

Tax Issues

Gift Taxation of SNTs

a. (d)(4) or other Self Settled Trusts – If a trust is subject to creditor's claims under NC law, the transfer to a self settled trust is not a completed gift and therefore not subject to gift tax. Under North Carolina's version of the Uniform Trust Code, N.C.G.S. §36C-5-505(a)(2), with respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit. Therefore, generally all self settled trusts in North Carolina are not subject to gift tax.

b. Testamentary 3rd Party Trusts – Generally gift taxes are not an issue for testamentary trusts.

c. Intervivos Third Party Trusts – Generally 3rd party funded trusts are not eligible for the annual exclusion because the gift is not a present interest unless: the gift is not a completed gift by retention of a general power of appointment; the gift is made a present interest give because of a lapsed Crummy power

Income Taxation of SNTs

a. (d)(4) or other Self Settled Trusts – Taxable income is taxable to the grantor/beneficiary whether or not it is distributed. Therefore, the trustee of a (d)(4) trust should have the power to pay the beneficiary's income taxes.

b. Testamentary 3rd Party Trusts – Taxable income is taxable to the trust unless it is distributed, then it is taxable to the beneficiary; or the beneficiary is given a power of appointment. **(If giving a beneficiary a power of appointment, be careful as this may also cause assets to be considered a resource causing benefit eligibility problems)**

c. Intervivos Third Party Trusts - Taxable income is taxable to the trust unless: it is distributed, then it is taxable to the beneficiary; the trust is drafted to make it a defective grantor trust by giving the grantor one or more powers under IRC §§ 671-677: retention of a special power of appointment; power to substitute trust corpus; income, in grantor's discretion, can be distributed to grantor or grantor's spouse; power to remove trustee; the beneficiary is given a power of appointment **(See above cautionary notes)**; or the beneficiary is made the grantor by lapse of Crummy powers.

Estate Taxation of SNTs

a. (d)(4) or other Self Settled Trusts – Since the funding of a self settled trust in North Carolina is not a completed gift, the trust will be included in the grantor/beneficiary's gross estate for estate tax purposes at date of death values.

b. Testamentary 3rd Party Trusts – The trust assets are generally subject to estate tax in the estate of the decedent. The remainder in the trust after the beneficiary's death should not be subject to estate tax unless the beneficiary has been given a general power of appointment. **(See above)**

c. Intervivos Third Party Trusts – Generally not included in the grantor's estate at death unless the grantor retains strings to cause inclusion in the grantor's estate under IRC sec 2033-2041.