

USING SPECIAL NEEDS TRUSTS FOR ELDERLY CLIENTS

A. What are Special Needs Trusts

An elderly or disabled person who is eligible for means-tested public benefits, such as Medicaid or Supplemental Security Income, is generally not going to enjoy a luxurious lifestyle. A special or supplemental needs trust (SNT) is a trust that provides distributions in kind to a person to satisfy his or her needs left unmet by public benefits without disqualifying the person from receiving the public benefits. SNTs are consequently an important tool in improving a beneficiary's quality of life. SNTs are a statutory exception to the general rules set forth in 42 U.S.C. § 1396p(d) regarding the treatment of trusts established by an individual as income and assets for the purpose of determining the individual's public benefit eligibility.

Since 42 U.S.C. § 1396p(d) applies only when an "individual" establishes a trust for a corpus that includes all or part of the individual's assets "other than by will," two types of SNTs or supplemental needs trusts that may be formed without disqualifying a person from public benefits eligibility are third party SNTs and testamentary SNTs. In addition, 42 U.S.C. § 1396p(d)(4) provides for additional explicit statutory exceptions, typically referred to as D4A and D4C trusts, to the requirements imposed by 42 U.S.C. § 1396p(d) to count trust income and assets.

If a SNT is formed by a person other than the disabled individual beneficiary, the individual's spouse (or person who is deemed financially responsible for the disabled beneficiary), a person (including a court) with legal authority to act on behalf of the individual, or a person (including a court) acting at the direction of the individual, it is deemed to be a third party SNT if the funds comprising the corpus of the third party SNT

come exclusively from a third party. A third party-created discretionary non-support trust may provide for the beneficiary's supplemental needs without a State payback provision. Third party SNTs may be revocable or irrevocable. In addition, a testamentary SNT may be created without a State payback provision because 42 U.S.C. § 1396p(d) does not apply to assets in a trust created by a will.

D4A and D4C trusts are governed by 42 U.S.C. § 1396p(d)(4), which provides in relevant part as follows:

(4) This subsection shall not apply to any of the following trusts:

(A) A trust containing the assets of an individual under age 65 who is disabled (as defined in section 1382c(a)(3) of this title) and which is established for the benefit of such individual by a parent, grandparent, legal guardian of the individual, or a court if the State will receive all amounts remaining in the trust upon the death of such individual up to an amount equal to the total medical assistance paid on behalf of the individual under a State plan under this subchapter.

(C) A trust containing the assets of an individual who is disabled (as defined in section 1382c(a)(3) of this title) that meets the following conditions:

(i) The trust is established and managed by a non-profit association.

(ii) A separate account is maintained for each beneficiary of the trust, but, for purposes of investment and management of funds, the trust pools these accounts.

(iii) Accounts in the trust are established solely for the benefit of individuals who are disabled (as defined in section 1382c(a)(3) of this title) by the parent, grandparent, or legal guardian of such individuals, by such individuals, or by a court.

(iv) To the extent that amounts remaining in the beneficiary's account upon the death of the beneficiary are not retained by the trust, the trust pays to the State from such remaining amounts in the account an amount equal to the total amount of medical assistance paid on behalf of the beneficiary under the State plan under this subchapter.

¹ D4B trusts, which are also referred to as Miller trusts or income trusts, are not covered in this paper.

D4A trusts are SNTs that are established under subsection 1396p(d)(4)(A). In order to establish a valid D4A trust for your client, he or she must be both younger than 65 and disabled. Whether a client is disabled is determined by reference to 42 U.S.C. § 1382c(a)(3), which specifies that an individual is disabled “if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than twelve months.” The age restrictions of a D4A trust obviously limits its availability to elder clients. Another restriction on the availability of D4A trusts to clients in general is the prohibition on the individual beneficiary creating the trust for himself or herself. D4A trusts must be established for the benefit of the individual by a parent, grandparent, legal guardian, or the court. After all of the eligibility restrictions applicable to the beneficiary of a D4A trust are satisfied, the trust must also provide for a Medicaid lien that allows the State to receive the remainder of the trust upon your client’s death, up to an amount equal to the total medical assistance paid on the disabled beneficiary’s behalf. D4A trusts should be irrevocable.

D4C trusts are SNTs that are established under subsection 1396p(d)(4)(C) and are typically referred to as pooled trusts. If your client is 65 or older or must establish his or her own SNT, the only available choice is a pooled trust. In order to establish a valid D4C trust for your client, the settlor of the trust must be the disabled beneficiary or that person’s parent, grandparent, or legal guardian or a court. The trust must be established solely for the benefit of the disabled beneficiary and should be irrevocable. The pooled trust must either retain the corpus of the trust at the time of disabled

beneficiary's death or pay the State pursuant to a Medicaid lien an amount equal to the total amount of medical assistance paid on behalf of the beneficiary under the State plan.

B. When to Use Special Needs Trusts in Estate Planning

For elder clients, SNTs are used when the client needs to secure or retain government assistance for his or her basic needs and can benefit from the satisfaction of his or her supplemental needs without jeopardizing eligibility for government assistance. While a financial power of attorney or a guardianship of an estate may be sufficient to handle the estate of a person who lacks capacity, a SNT will allow a disabled client's assets to be removed from his or her estate without disqualifying the client for Medicaid or other government assistance. North Carolina law actually permits a guardian of the estate "[t]o create a trust for the benefit of the ward pursuant to 42 United States Code § 1396p(d)(4), provided that all amounts remaining in the trust upon the death of the ward, other than those amounts which must be paid to a state government and those amounts retained by a nonprofit association as set forth in 42 United States Code § 1396p(d)(4)(C), are to be paid to the estate of the ward." G.S. 35A-1251(23).

SNTs are typically used for a beneficiary with a life expectancy that is long enough that the beneficiary's future needs are reasonably expected to exceed the beneficiary's resources. SNTs can also be used when the client will be receiving a significant payment from a personal injury claim, insurance, or inheritance. Proceeds from any claim must be owned by the SNT. If the beneficiary is under 65, the court can

be asked to order that the payment for the claim be paid directly into a D4A SNT in order to preserve the client's eligibility for government assistance.

If the disabled beneficiary is under 65, a choice must be made between the D4A and D4C trusts. Two primary issues that must be resolved to make the selection are the desire for control and the cost-effectiveness of the choice. If a family prefers control over the trust and its distributions, the family will request a D4A trust. However, if the expected corpus of the trust is not significant, the cost of the creating and managing the trust and the difficulty in attracting a competent trustee to manage or assist in managing the trust may eliminate the D4A trust as a viable choice. Be sure to satisfy creditors of the beneficiary before a SNT is created.

C. Why Special Needs Trusts Are Used

Qualification for certain public benefits such as Medicaid and SSI is subject to income and asset limits.² If a Medicaid applicant (or a Medicaid recipient who receives assets after qualifying for benefits) gifts or transfers assets at less than fair market value in an attempt to bring the applicant's assets below the applicable resource limit, the applicant will suffer a significant period of disqualification for public benefits support if the gift or transfer was made within the applicable look-back period. The length of the disqualification period will depend upon the amount gifted by the applicant.

Rather than gifting resources or transferring resources at less than fair market value and risking disqualification, applicants for Medicaid who are disabled can reduce their countable resources by transferring resources to SNTs. In addition, family members who wish to support Medicaid recipients can use third party and testamentary SNTs to provide for certain needs without disqualifying the recipient of the Medicaid

² This paper does not provide comprehensive Medicaid planning information.

benefits. The North Carolina Department of Health and Human Service, Division of Medical Assistance, Adult Medicaid Manual MA-2230, Section XI provides detail as to how a trust is evaluated in determining whether it is a countable resource for the purpose of determining Medicaid eligibility.

The Adult Medicaid Manual makes clear that “[b]ills paid by a third party for an item other than food or shelter” are non-countable sources of unearned income for applicants for and recipients of Medicaid benefits. By using a SNT to provide “luxuries” such as televisions, digital video recorders, games, appliances, computers, internet access, telephones, personal care products, clothing, and vacations, the dignity and quality of life of the disabled beneficiary will be preserved, even if the SNT beneficiary survives his or her family members. Third party and testamentary SNTs also allow a trust beneficiary to receive supplemental support during his or her lifetime while helping to potentially preserve the value of the estate (that would otherwise be spent for the trust beneficiary’s medical care) for the benefit of remainder beneficiaries, such as siblings of the trust beneficiary. After satisfying the payback obligation, D4A trusts may yield a portion of the corpus to remainder beneficiaries.

Two additional benefits available from SNTs are: (1) the deferred payback of Medicaid expenditures, which effectively provides an interest free loan to the disabled beneficiary during his or her life, and (2) the medical costs charged to the trust at the time of the payback will likely be less than the medical costs the disabled beneficiary would have incurred on his or her own because Medicaid generally pays out less than private payers.

D. How Special Needs Trusts Work

If created and managed correctly, a SNT does not give distributions of money directly to a disabled public benefits recipient because the distributions would be deemed unearned income that could reduce or eliminate the recipient's qualification for public assistance. Instead, the trustee distributes property that will not be a countable resource, such as a television, to the disabled beneficiary rather than the money to purchase a television. In order to make these in-kind distributions, the trustee pays the vendor for the television from the income or principal of the SNT. In-kind distributions that are made must be made for the benefit of the disabled beneficiary. In order to ensure that a SNT will fulfill its intended purpose, the trustee must be given the discretion to determine whether distributions will be made to the beneficiary, and the disabled beneficiary must not have access to the trust corpus or entitlement to trust income. In addition, the SNT should be drafted in a manner that explains its purpose to the trustee and notifies the trustee that the trustee is not to make disqualifying distributions, such as payments for food or shelter, for the disabled beneficiary.

For example, the SNT may advise the trustee to pay or apply for the benefit of the disabled beneficiary for his or her lifetime such amounts from the principal or income, or both, of the trust up to the whole thereof, as the trustee, in the trustee's sole, absolute, and unfettered discretion, may from time to time deem necessary or advisable for the satisfaction of the disabled beneficiary's special and supplemental non-support needs. In carrying out the provisions of the trust, the trustee should remain mindful of the probable future needs of the disabled beneficiary. Any income not distributed can be added annually to the principal of the trust.

The "special and supplemental non-support needs" that may be satisfied from the trust refer to the needs of the disabled beneficiary that are not being met by any public financial assistance or public agency, the satisfaction of which does not disqualify the disabled beneficiary from the receipt of or the eligibility for the public financial assistance or other public benefits. No part of the corpus of the trust should be used to supplant or replace public assistance benefits of any county, state, federal or other governmental agency that has a legal responsibility to serve persons with disabilities that are the same or similar to those which the disabled beneficiary is or may be experiencing. The trust can specify that for purposes of determining the disabled beneficiary's public assistance eligibility, no part of the principal or undistributed income of the trust should be considered "available" to the disabled beneficiary, and no interest in the principal or income of the trust should be anticipated, assigned or encumbered or should be subject to any creditor claims or to any legal process.

Furthermore, because the trust should be conserved and maintained for the special and supplemental non-support needs of the disabled beneficiary throughout his or her life, no part of the trust corpus, whether principal or undistributed income, should be construed as part of the disabled beneficiary's estate or be subject to the legal or equitable claims of voluntary or involuntary creditors, including those who have provided for the disabled beneficiary's care and services. The trust should also specify that under no circumstances can the disabled beneficiary compel a distribution.

The discretionary authority vested in the trustee makes the selection of the SNT trustee very important. The trustee must be trustworthy and possess good judgment and should be capable of qualifying for a fiduciary bond if needed. In addition to

carefully selecting the initial trustee, the SNT should identify the series of persons and entities who are to serve as trustee in the event the initial trustee is unwilling or unable to serve. Some SNTs utilize either trust committees or co-trustee arrangements that include both family members and professionals such as attorneys and investment advisors. SNTs can also require the trustee(s) to report periodically on trust activities to a third party, who is often referred to as a trust protector and who is typically given the authority to discharge the trustee. The family members involved in the process of creating the SNT should consider providing a nonbinding letter of instruction to successor trustees to explain the family's values and the beneficiary's personal preferences.

For pooled trusts, a non-profit association manages a single pooled fund, but the money contributed by or on behalf of a disabled beneficiary is tracked for him or her as a sub-account of the pooled trust. During the disabled beneficiary's lifetime, earnings of the pooled trust attributable to the disabled beneficiary's sub-account are generally available to satisfy the special needs of the disabled beneficiary. These earnings are typically applied in accordance with directions or information from the family members involved in transferring resources to the pooled trust. Some pooled trusts provide coordinators whose job is to interact with and advocate for the disabled beneficiary. After the disabled beneficiary's death, any assets retained by the pooled trust are typically used to provide resources for other beneficiaries whose contributions have been completely spent or to pay for trust operating costs.

While pooled trusts enjoy the advantage of professional management, the retention of assets after the death of the disabled beneficiary and the lack of family

control over trust disbursements can limit the desirability of pooled trusts for some settlors.