SPECIAL NEEDS TRUSTS AND THEIR IMPORTANCE
<u>FOR ASSET PRESERVATION</u>

I. Introduction.

A. Many arrangements and types of ownership of property can be utilized to achieve particular asset preservation goals and objectives.

1. Tenants by the entirety ownership of property between a husband and wife automatically provides limited protection against claims by some third parties and for certain public benefits purposes.

2. Long-term care insurance can provide a mechanism to pay for long-term care, thus freeing up other assets and allowing time to work to the advantage of certain transferors who may have divested themselves of assets or made transfers to trusts which may have given rise to a period of ineligibility for public benefits.

B. In the area of asset preservation, the particular areas of concern may pertain to tax avoidance, avoiding claims of third parties, protecting or obtaining eligibility for public benefits, or preserving or providing for liquidity needs of a decedent's estate.

1. The focus of this presentation will be on trusts.

2. Particular emphasis will be placed on special needs trusts.

C. Why is asset preservation and special needs planning so important?

1. How can an individual provide for his own needs and/or the needs of his spouse, while maintaining as much control as possible without "tainting" the asset protection arrangement being utilized?

2. How do you leave funds for the benefit of a child without causing a child to loose important public benefits?

3. How do you make sure that the funds are well managed?

4. How do you make sure that your other children are not overburdened with caring for a disabled sibling, and any burdens fall relatively evenly among the siblings?

5. What is fair in terms of distributing your estate between your disabled child and your other children?

6. How do you make sure there is enough money available to meet your disabled child's needs?

D. A trust of one or another type will generally be the most efficacious and flexible vehicle for addressing these issues. See Clifton B. Kruse, Jr., *Third Party and Self-Created Trusts*, Third Edition, ABA Section of Real Property, Probate and Trust Law (2002).

II. Using Trusts for Asset Preservation.

A. The following are the standards commonly set for distributions by the trustee of a trust:

1. Mandatory distribution of "income" only (the meaning of "income" to be determined by the trust and/or state law, including possibly the Indiana Uniform Principal and Income Act, I.C. 30-2-14-1, *et seq.*); in general, "income" would not include capital gains. Such a mandatory provision would not require exercise of discretion.

2. Distribution provisions with "discretion" to "spray" income and/or principal among the beneficiaries pursuant to a standard.

a. With less discretion, opportunities for asset preservation are reduced.

(1) A "support" standard will make the trust a support trust, which will be subject to claims by Medicaid agencies and other third parties.

(2) Using an "ascertainable standard" which might include support; or which might not, is often used so that the beneficiary may serve as the trustee without the trust being included in the beneficiary's estate. Such a trust would usually be subject to claims.

b. "Absolute" discretion with no objective standard makes the trust a fully discretionary trust which can likely be immune from the claims of creditors if spendthrift provisions are used, and possibly, but not necessarily, protected from claims of Medicaid agencies and other third parties.

c. "Absolute" discretion with instructions not to make distributions that would reduce or replace government benefits is the basis of a "special needs trust."

3. Although not intended to represent an exhaustive analysis of Indiana law on the issue of third-party created trusts where the settlor retains no beneficial interest, the following may be expository:

a. *Sisters of Mercy Health v. First Bank*, 624 N.E.2d 520 (Ind.App. 1993) (trust contained a spendthrift provision, but the trust was not insulated from a third-party claim; involved a testamentary trust established by the beneficiary's spouse; medical necessities furnished by the plaintiff were not paid by the trustee; there was no express prohibition relating to the trust's payment for medical necessities; absent such express direction to the trustee, both Indiana policy and the decedent's presumed intent were found to support enforcement of payments to the creditor for necessities furnished to the beneficiary).

b. See also *Robison v. Elston Bank & Trust Co.*, 48 N.E.2d 181, 187 (Ind.App. 1943), *reh'g denied*.

c. For an enlightening although slightly dated discussion of the powers that a donor can retain over transferred property, see <u>Estate Planning</u>, Vol. 24, No. 27, Digby, "What Powers Can a Donor Retain Over Transferred Property?"

B. What works and what doesn't?

1. To the extent the grantor has control, those assets will be considered available and vulnerable to creditors.

2. A non-grantor beneficiary who does not have control may have protection depending on the terms of the trust and applicable state law and whether or not the beneficiary has the power to compel distributions.

a. A "spendthrift" provision will provide protection, generally, against claims by third parties.

b. Note, however, that the IRS may be able to levy upon even a spendthrift trust. See <u>IRS v. Orr</u>, 180 F. 3d 656 (5^{th} Cir. 1999).

3. Trusts must be irrevocable in order to protest assets. Be aware, however, of the gift tax and other tax implications of irrevocable and other trusts.

4. Trusts can be used if planned effectively to protect assets for a beneficiary who is receiving public benefits or who may require long-term care.

a. In general, trusts in which the Medicaid applicant or the spouse retains an interest will not be protected and will generally be counted as available. One exception is the "income only" trust pursuant to which "only income" is payable to the grantor-beneficiary, but not principal. The principal may be immunized, subject to the transfer penalty implications.

b. A trust for a surviving spouse intended to meet only special needs and not count as the spouse's assets **must** be established under a will, i.e., a testamentary trust, and not a living trust, so that the assets will not be counted as "available" to the surviving spouse. 42 U.S.C. §1396 p(d)(2)(A): ICES Program Policy Manual §2615.75.20.10.

5. The chart attached as Exhibit "A" identifies various types of trusts, how they are created, and the Medicaid and other implications of those trusts.

C. Self-settled versus third-party trusts.

1. Supplemental needs or special needs trusts can be divided into two (2) classes: those created and funded by someone other than the person receiving public benefits, and those funded with the beneficiary's own funds.

2. In most cases, trusts created with personal injury settlements will fall in the latter category.

3. For such "self-settled" trusts, both the Medicaid and SSI rules are very strict regarding the trusts that will be exempt for eligibility purposes. Trusts that do not meet a safe-harbor will be counted as belonging to the applicant, rendering him or her ineligible for benefits.

D. Trust funding.

1. How do you determine how much to put into the trust?

2. How much will your spouse, child or other beneficiary with special needs require over his or her life?

3. The use of a financial planner with experience in this area can help make projections to assist with the appropriate determinations.

4. It may be better to commit more money, rather than less, since you cannot be certain that current programs will continue, and it may be necessary to pay for services, such as case management, that may be available without charge today.

5. Consider the use of life insurance as a means of supplementing your estate in order to meet the various needs of all of the beneficiaries.

E. Personal injury cases.

1. Must evaluate the advantages and disadvantages of a lump sum versus a structured settlement, and placing the settlement proceeds in trust.

Structured settlements are virtually risk free and the annuities acquired are essentially never taxed, which may cause a structured settlement with a lower return to be equivalent to a taxable investment with a higher return.

2. The drawback of a structured settlement is its inflexibility; it does not permit certain major purchases, and it can destroy a client's current or future eligibility for public benefits.

3. Cash settlements offer complete flexibility both in terms of when the funds will be available to make a large purchase, such as a home or handicap van, and being able to take advantage of and respond to fluctuations in the market.

4. A combination approach, particularly utilizing a special needs trust, can work well and provide the best of all worlds.

F. Alternatives to trusts for the preservation of assets.

1. Purchase exempt resources, such as a motor vehicle or home.

2. Pay off debt, including mortgages and credit cards.

3. Prepay bills.

4. Give up needs based benefits and rely on the individual's resources, income and non-needs based benefits.

5. Personal service contracts for a limited term or for life. There are significant tax implications, however, of personal service agreements, particularly in the case of appreciated assets which are transferred to the care provider in exchange for the agreement to provide care in accordance with the personal service agreement. Refer to Indiana Revenue Code §83 and the regulations promulgated thereunder.

6. Prepayment of room and board for limited term or life.

III. Transfers of Assets Generally.

A. OBRA 1993 (OBRA), Pub. L. No. 103-66, 107 Stat. 213, applies to assets disposed of after August 10, 1993 and trusts established after that date.

B. The "look-back period" for identifying uncompensated transfers of assets under ORBA was 36 months except in the case of payments to or from a trust or portions of a trust which are treated as disposed of by the individual, which were subject to a 60-month "look-back period."

1. For those who apply for Medicaid subsequent to admission, the period runs from the date of the application.

2. For those who enter an institution while receiving Medicaid, the look-back period is dated back from the date of admission.

3. The Deficit Reduction Act of 2005, Pub. Law 109-171 (the “DRA”) extended the look-back date to a date that is 60 months after the date of enactment of the DRA (February 8, 2006), subject to the extension of effective date provisions of the DRA to accomplish state law amendments [§ 6016 (E)(3)].

   a. Indiana's final rule was filed with the Indiana Secretary of State on August 18, 2009 and published in the on-line Indiana Register on September 16, 2009 at www.in.gov/legislative/iac/20090916-IR-405080325FRA.xml.pdf. On November 1, 2009, the FSSA published a memo explaining how it intends to implement those provisions. The memo is available on-line at www.in.gov/fssa/files/Transfer_of_Property_Asset_Provisions_Effective_11-09.pdf. FSSA has not yet incorporated these changes into its ICES Manual.

   b. It should be noted that the change to a 60-month look-back period will not instantly give rise to the need to provide Medicaid caseworkers with five years of transfer data.

   c. Except in the case of trusts, in the first month after the effective date, only 37 months of transfer data would be required, and in the second month after effectiveness, only 38 months of data would be required, etc.

   d. While a transfer made after the effective date would presumably impact eligibility for up to five years, any previous transfers which occurred would not be affected by the change in the look-back period.

   e. The change to a 60-month look-back period will encourage the utilization of trusts in light of the pre-DRA five-year look-back period applicable to trust transfers.

C. There is currently no penalty, speaking generally, for a person at home receiving regular Medicaid except in the case of certain waivered services (Home and Community-Based Services under the Developmental Disabilities, Autism, Assisted Living, Support, Service or Medically Fragile Children’s Waivers).

D. The applicable penalty period is determined by dividing the value of the property transferred by a set rate.

1. For transfers prior to July 1, 2002, there were three regions, and the divisor depended on the region in which the Medicaid application was filed.

2. Since July 1, 2002, there is one rate, which as of July 1, 2009 was $4,611.

E. The following are the major changes between pre-DRA and DRA transfers.

	Transfers before 11/01/09	**Transfers On or After 11/01/09**
Look-Back Period	3 years; 5 years for some trusts	5 years
Beginning date of Penalty	Month After Transfer	When otherwise eligible for Medicaid with an approved application or month in which transfer occurred, whichever is later
Multiple Transfers	Treated separately unless occur in same or consecutive months	Add them all together
Partial month penalties	No partial month penalties; round down to nearest whole number of months	Can be partial month penalties. Calculated as number of months and days.

Remember that it is the penalty period which controls and not the look-back period.

1. The look-back period circumscribes the maximum penalty effect of a transfer if the Medicaid application is filed after the period has elapsed.

2. Note, however, that the DRA significantly impacts how the Medicaid penalty will be calculated if the application for Medicaid occurs within the DRA-mandated 60-month look-back period.

3. For a partial month, the penalty calculation is rounded up at the second decimal place (hundredths), and the fractional part of the penalty period is multiplied by 30.42 (since there are 30.42 days in an average month) and rounded up to determine the number of days of eligibility. For example, a $30,000 transfer divided by the divestment penalty divisor of $4,611 would give rise to a penalty of 6.506 months, which would be rounded up to 6.51. The fractional part of .51 is multiplied by 30.42, which equals 15.51. This result is rounded up to 16. Consequently, the penalty period would be six months and sixteen days.

4. For additional information concerning the transfer penalty rules, see U.S.C. §1396p(c); the Indiana Administrative Code, 405 IAC. 2-3-1.1; and the Indiana Medicaid Manual, ICES Program Policy Manual §§2640.10.00 through 2640.10.35.20.

F. SSI Trust and Transfer Rules.

1. The SSI resource transfer rules are very similar in structure to the current Medicaid transfer of asset rules. The "look-back period," however, is always 36 months in the case of SSI.

   a. It was several years after the adoption of OBRA 93 before the SSI transfer rules were amended to be more consistent with the Medicaid rules applicable to divestment and which established a 36-month look-back period for SSI transfers.

   b. After the DRA, a significant inconsistency now exists again between the impact of divestment for SSI purposes as compared to the impact for Medicaid purposes.

2. The "penalty period" (that period of time during which a person cannot receive SSI because of a transfer) can never be more then 36 months, while there is no "cap" on Medicaid transfers except to the extent that the "look-back period" applies, and is calculated by dividing the amount gifted by the maximum SSI benefit (federal benefit plus state supplement, if applicable) which the individual could receive based upon his or her living arrangement (in 2010, $674 for an individual and $1,011 for a couple).

3. As in the case of Medicaid, certain transfers of a home may be exempted (e.g., if to the spouse of the transferor, a child of the transferor who has not attained 21 years of age or is blind or disabled, a sibling of the transferor who has an equity interest in the home and who resided in the transferor's home for a period of at least one year immediately before the date the transferor becomes institutionalized, etc.), as well as other transfers of resources to the spouse, and transfers to certain Medicaid exempt trusts.

4. Under current SSI regulations, anything received by an individual during the course of a month, such as the settlement of a personal injury case, is income. It does not lose its character as income and become a resource until the first moment of the following month. Consequently, the transfer of the settlement proceeds may affect SSI during future months, and of course, in any event, the receipt of "income" in the month of receipt will affect the SSI benefit for that month.

5. The SSI transfer penalty rules apply only to transfers occurring on or after December 14, 1999. No penalty applies to transfers that took place before that date. Also, transfers giving rise to a penalty may be "cured" by the

person to whom the gift was made by returning the gift to the transferor. Again, as previously noted, there are many exceptions to the transfer rules, as in the case of Medicaid, such as a trust for the benefit of a blind or disabled child, and so called “under age 65” (d)(4)(A) trusts and a (d)(4)(C) “pooled trust."

G. Benefit programs that will not be considered in this presentation since they are not based on need:

1. Social security disability.

2. Medicare.

3. Special education under the Individuals with Disabilities Education Act.

4. Civil service and military survivor benefits for disabled adult children.

5. In the case of programs that are not means-tested, there is no need for a special needs trust unless means-tested programs are anticipated in the future.

H. Benefit programs based on financial need:

1. Housing choice voucher program (“Section 8“).

a. A federal subsidy to assist with monthly housing cost; the household pays a portion of monthly housing costs based on the income of the household (usually equal to 30 percent of the household’s monthly adjusted income).

b. Administered by a public housing agency (“PHA”) under a contract with U.S. Department of Housing and Urban Development (“HUD”).

c. The Section 8 program is income-tested, not resource-tested. To be eligible for the Section 8 program, an applicant must not have income that exceeds the applicable income limit (the income limits used to determine eligibility vary by program from 30 percent of the median income for the area to 95 percent). Income from resources is counted as income to the tenant, and if the tenant transfers resources, income is imputed to the tenant at the rate of 2 percent per year.

d. The Section 8 program does not specifically exempt (d)(4)(A) or (d)(4)(C) SNTs, but has its own rules relating to irrevocable trusts.

e. Pursuant to *HUD Handbook* 4350.3 REV-1, § 5-7, www.hudclips.org.

(1) A Section 8 applicant must report all income earned by his or her assets or two percent per year if no income is earned on an asset.

(2) If no family member has access to either the principal or income of the trust at the current time, the trust is not included in the calculation of income from assets. Therefore, (d)(4)(A) SNTs should not be considered an asset if no family member who resides in the Section 8 housing is a trustee of the trust.

(3) Distributions from the trust on a recurring basis to the applicant (other than for groceries) will be considered in the applicant's annual income. Temporary, non-recurring or sporadic income (including gifts) is not counted.

(4) Generally, the creation of the trust is considered an asset disposition for less than fair market and the applicant must count the assets transferred to the trust for eligibility purposes for two years. However, there is an important exception for trusts funded with the proceeds of a litigation settlement or judgment. These assets are excepted from the two-year rule.

(5) In general, to avoid income inclusion issues, payments from trusts need to be irregular and sporadic, and the tenant should not have access to the income, nor should the tenant be a trustee of the trust.

2. Although a complete analysis of veterans benefits will not be addressed in this presentation in any significant way, the following matters should be noted:

a. A veteran who has served as little as 90 days of consecutive active duty service of which as little as one day was during a war-time period, and who received an other than dishonorable discharge, may be entitled to a Special Monthly Pension ("SMP") to offset the cost of necessary healthcare.

b. Two type of SMP are available:

(1) "Housebound" benefits.

(2) Aid and Attendance ("A&A") benefits.

c. Housebound benefits are available to a veteran or widow(er) who is determined to be disabled and essentially confined to the home.

(1) A significant disability is required.

(2) People age 65 and older are presumed to be disabled.

d. A&A benefits are available to a veteran or widow(er) or a veteran who is blind, living in a nursing home, or unable to attend to certain activities of daily living.

(1) If the claimant needs daily services without which he or she would need nursing home, hospital or institutional care, then he or she would be entitled to A&A benefits.

(2) See 38 U.S.C.S. § 1502(b) and 38 C.F.R. §§ 3.352(a), 3.351(c)(3).

e. For the permissible family income limits to precede either housebound or A&A benefits, see www.va.gov.

f. To file for SMP benefits, an applicant must present an application to the Veterans Affairs office.

(1) Applications are now available on line, but supporting documentation must be sent separately to the VA.

(2) For information on the different offices, see www.vetsresource.com and www.vba.va.gov/VBA/.

g. Veterans may obtain free assistance with filling out the application from accredited veterans service organizations. Organizations or individuals, including attorneys, are not permitted to charge fees for assisting a client with the application process. However, if the claim is denied or approved for less benefits than expected, the claimant may hire a paid representative to assist in the appeal. An advisor may also charge for planning and advice.

h. Other VA benefits that will not be addressed include claims for dependency and indemnity compensation and VA health care.

i. For the purpose of determining VA pension benefits, the assets in a self-settled special needs trust must be considered in determining eligibility for a VA pension. Department of Veterans Affairs, Office of the Regional Council, Washington, DC, VAO Pg. Cp. Rec. 33-97.

IV. **Types of Special Needs Trusts**.

A. Third-party created trusts.

1. In general, if absolutely discretionary and not created for a spouse, such trusts may be established either as intervivos trusts or as testamentary trusts with no public benefits consequences if administered properly.

2. As previously noted, however, for Medicaid purposes, a special needs trust created for the benefit of a spouse can only be established pursuant to the deceased's spouse's last will and testament (i.e., a testamentary special needs trust for the benefit of the surviving spouse).

    a. The basic element of asset preservation planning for a spouse is the establishment of a testamentary special needs trust for the surviving spouse in anticipation of the death of the predeceasing spouse.

    b. In order to plan effectively and accomplish a flexible result, particularly if circumstances change or the anticipated consequences do not come to fruition, it may be necessary for both spouses to execute a last will and testament containing testamentary special needs trust provisions for the surviving spouse, and then to retitle assets and/or coordinate appropriate beneficiary designations, and perhaps change those arrangements from time to time, in order to protect the presumptive surviving spouse prior to the death of the presumptive predeceasing spouse.

3. In general, a third party trust does not need to be established for the "sole benefit" of a beneficiary, and can include a number of beneficiaries. Consequently, more tax planning opportunities are available, including the ability to distribute IRA and other qualified distributions among a number of beneficiaries in order to avoid the income tax "trapping" problem that can exist in the case of a "sole benefit" special needs trust.

B. 42 U.S.C. §1396p(d)(4)(A) [SSA §1917(d)(4)(A)] Trusts.

1. These are the so-called (d)(4)(A) disability trusts which may be established by a parent, a grandparent, a legal guardian, or the court, with assets of a Medicaid beneficiary who is under 65 years of age.

    a. The POMS make it clear that to "establish" a (d)(4)(A) trust means to take the physical action to sign the trust.

    b. A legally competent disabled adult may then transfer his/her own assets into the trust, or another individual acting under a validly created power of attorney may transfer the assets, but the disabled individual may not "sign" the trust.

    c. In the case of a trust established through the actions of a court, the creation must be by court order, effectively having the judge sign the trust or ordering a party to sign the trust under court order. If a court only allows or ascents to a trust signed by a third party (other than a parent, grandparent or guardian), then the trust will be invalid.

d. The POMS also address the use of a power of attorney, i.e., stating that a power of attorney which has been validly created according to state law by a parent or grandparent may be used by the independent agent to establish a trust for the beneficiary on behalf of the parent or grandparent. POMS SI 01120.203B 19.

2. This type of trust does not give rise to a Medicaid transfer penalty, and the assets in the trust are protected as long as they are used to provide for the "supplemental needs" of the beneficiary and not for support.

3. The assets transferred for the beneficiary might be funds received from an inheritance or a personal injury settlement. The excess resources could be transferred to a (d)(4)(A) trust without incurring a Medicaid penalty. The beneficiary's eligibility for Medicaid and SSI would not be affected.

4. The income will be attributable to the beneficiary for income tax purposes, in most instances, but as long as it is used to provide for the beneficiary's "special needs," no disqualification for Medicaid or SSI should occur.

5. Upon the death of the beneficiary, however, the remainder must be made available to the state Medicaid agency for reimbursement of medical assistance. This is the so-called "pay-back requirement."

6. Attached as Exhibit "B" is a form of (d)(4)(A) trust.

7. Remember that for all forms of special needs trusts based on disability, the definition of "disability" is the same definition contained in the Social Security Act for determining eligibility for SSI or SSDI. 42 U.S.C. §1382c(a)3A. If a special needs trust is being considered before the beneficiary has been determined to be disabled by the Social Security Administration, consider obtaining an advisory opinion from an experienced Social Security Disability attorney as the foundation to proceed in drafting the special needs trust. The POMS provide that if there has not been a determination of disability, the case can be sent for a medical determination after the trust has been established. POMS SI 01150.121.

8. A self-settled trust of this type may be helpful to deal with a tort recovery, an inheritance or any other unanticipated payment. Although certain payments might be deemed to be income rather than assets, an irrevocable assignment of child support or alimony payments made directly to a trust as a result of a court order are not income, as long as the assignment is irrevocable. POMS SI 01120.200G.1.d.

a. The POMS clarify that special rules apply to trusts established with the assets of an individual on or after January 1, 2000. POMS SI 01120.201B.7.

b. There is an example of a disabled SSI recipient over age 18 who receives child support, which is assigned by court order directly into the trust. Since the child support is the SSI recipient's income, the recipient is the grantor of the trust, and the trust is a resource unless it qualifies as a self-settled special needs trust. POMS SI 01120.201C.2.b.

c. This clarifies that child support is the recipient's income and must be diverted to a first party special needs trust rather than a third party special needs trust. The same reasoning would presumably apply to alimony.

9. Payments under a structured settlement received after age 65 do not disqualify the trust from self-settled special needs treatment, so long as the structure was in place prior to age 65.

10. A (d)(4)(A) trust must be established for the "sole benefit" of a beneficiary.

C. 42 U.S.C. §1396p(d)(4)(B) [SSA §1917(d)(4)(B) Trusts.

1. These are the so-called “Miller trusts” or “qualified income trusts” which apply most frequently in an income-cap state. This trust consists solely of pension, social security, and other retirement income, plus accumulated income on those trust amounts.

2. A (d)(4)(B) trust must provide that any sums remaining in the trust on the death of the beneficiary will first be used to repay the state for Medicaid expenditures.

3. The trust becomes the assignee of all periodic income of the beneficiary, and the income so assigned does not count toward Medicaid income eligibility, but is still treated as available income for the purpose of calculating the beneficiary’s duty to contribute to the cost of care as required under 42 CFR § 435.725(c). The same regulation directs that the cost of care contribution be reduced by a personal needs allowance, payments to a community spouse (to the extent necessary to bring the community spouse’s income up to the MMMNA level), and Medicare Part B premiums, among other items.

4. Mechanically, a (d)(4)(B) trust should be operated so that each month it receives all of the beneficiary’s income, and immediately makes payment to the nursing facility or the care provider, the beneficiary (for his or her

personal needs amount), and the spouse. Within a few days of the receipt of the monthly income, the trust account may be virtually emptied.

5. There is no requirement that personal needs be paid for directly from the trust account, nor that any unused personal needs accumulate.

6. Because the trust must provide for repayment of the state's Medicaid contributions at the beneficiary's death, there is good reason to maintain the trust balance at the lowest possible level.

7. Although Indiana is a "spend down" state and not an income-cap state, for certain waivered services (such as the developmental disabilities or DD waiver and the support services or SS waiver), the so-called SIL (special income level) test applies. The SIL is equal to the personal needs allowance used for the SS and DD waivers.

    a. If the individual fails the SIL-test (i.e., the income is more than the SIL), the individual is ineligible for the waiver.

    b. If the individual is married, the spousal impoverishment rules are applicable.

    c. Depending on the situation as explained in ICES Manual §3301.20.04, regular or spousal post-eligibility budgeting is used, and the amount of the personal needs allowance varies by waiver.

8. The SIL (or maximum income) for waived services is $2,022 as of January 1, 2009 (which did not change for 2010). This is equal to 300 percent of the maximum benefit payable under the SSI program, and increases annually when SSI increases in January of each year. In the case of an individual with a large monthly income who may be diverted from a nursing home to the home under the home diversion waiver, if the Medicaid recipient's income level is greater than the SIL, the individual would be ineligible for Medicaid for the purpose of the home diversion waiver. In other words, the individual could be eligible for Medicaid in the facility, utilizing the spousal impoverishment rules, but lose eligibility when he returns home under the diversion waiver because of the excess monthly income. Utilizing the (d)(4)(B) trust can avoid this result.

9. Attached as Exhibit "C" is a form of (d)(4)(B) trust. See also Regan, Morgan and English, *Tax, Estate & Financial Planning For the Elderly*, Section 10.13[1]([b]) p.10-133 *et seq* (2009).

D. 42 U.S.C. §1396p(d)(4)(C) [SSA §1917(d)(4)(C)] Trusts.

1. These are the so-called “pooled trusts” or “non-profit association trusts” such as the SWIRCA (Southwestern Indiana Regional Council on Aging, Inc.) Pooled Trust.

2. This trust may be established with the beneficiary’s assets by a parent, grandparent, a legal guardian, or the court, or by the beneficiary himself or herself, using his or her own assets.

3. As in the case of the (d)(4)(A) trust, this trust shelters the assets belonging to the person who is disabled, and should not affect the beneficiary’s Medicaid eligibility as long as the trust is used for supplemental needs and not for support.

4. As in the case of the (d)(4)(A) trust, the income will normally be attributable to the beneficiary for income tax purposes, but will not affect the beneficiary’s eligibility for Medicaid as long as it is used to provide for the beneficiary’s “special needs” and not to provide for the beneficiary’s support.

5. As in the case of a (d)(4)(A) trust, there is no transfer penalty, except for transfers of a beneficiary’s own assets if the beneficiary is 65 years of age or older.

6. As in the case of the (d)(4)(A) and (d)(4)(B) trust, there is a “payback requirement” to the state Medicaid agency for reimbursement for medical assistance except to the extent that the remaining assets stay in the trust.

7. Attached as Exhibit "D" is a copy of the SWIRCA (Southwestern Indiana Regional Council on Aging, Inc.) Pooled Trust Declaration, and attached as Exhibit "E" is a copy of the SWIRCA Pooled Trust Joinder Agreement.

E. Essential SSI (d)(4)(A) elements.

1. In addition to the statutory requirements of 42 U.S.C. §1396p(d)(4)(A), there are special SSI requirements.

2. Prior to August 15, 2002, some SSA Regional Counsel took the position that inter-vivos or post mortem payment of taxes, trustee fees, or other administrative expenses violated the Medicaid repayment requirement. The POMS were amended to make clear the “sole benefit” requirement is not violated if certain administrative expenses are paid during the life of the disabled beneficiary, and certain others are paid after death but before the repayment of Medicaid.

   a. The prohibited and allowable administrative expenses are found in POMS SI 01120.203B.3.

b. In general, taxes and reasonable fees may be paid. Payment of debts owed to third parties, funeral expenses (the “stinking dead body rule”), and payments to residual beneficiaries are not permitted.

3. Some regional offices have published regional instructions relating to what is necessary to have a valid irrevocable trust under state law. In certain states, the trust must specify a particular person or entity as the residual beneficiary. While “children,” “issue,” or “descendants,” is specific enough, “heirs” or “my estate” are not sufficient terms.

4. In certain states, any residual beneficiary, even an unborn child, is adequate for the purpose of establishing irrevocability. In others, as long as the trust names a residual beneficiary other than an unborn child, then the trust would be considered to be irrevocable. If the residual beneficiary is an unborn child or children, and the grantor has no child or children, and there is evidence that the grantor is unable to have children, then the trust might be considered to be revocable.

5. In certain states, if a specific person or entity is designated, it would also be permissible to name in addition an estate or heirs to establish a sufficient residual beneficiary.

6. Be careful of structured settlements, particularly if parents may be receiving annuitized payments in addition to the amount used to fund the child’s (d)(4)(A) trust. Since structured settlement annuities may be liquidated, they have been treated as a resource in some cases, even if the amount of the deemed income to the parent would not adversely affect the child’s SSI eligibility.

7. There are a number of definitional provisions in the POMS, such as the "fiduciary," the "trustee," and the "trust beneficiary," etc. See POMS SI 01120.200B.

V. Special Needs Trust (“SNT”) Basics.

A. Used for persons with disabilities in order to preserve eligibility for “needs-based” benefits.

1. The Social Security Act does not recognize an SNT *per se* for SSI purposes, but instead distinguishes trusts that are not an available resource to the beneficiary for the purpose of determining eligibility for SSI.

a. There is no federal statutory authority for a third party special needs trust.

b. However, authority is found in the POMS at SI 01120.200.

2. For SSI purposes, a discretionary trust is “a trust in which the trustee has full discretion as to the time, purpose and amount of all distributions.”

   a. If beneficiary has no control over the distributions, the trust is not counted as an available resource for SSI eligibility.

   b. Distributions from an SNT for a beneficiary receiving “needs-based” benefits may trigger both tax and public benefits consequences.

   c. "If an individual (claimant, recipient, or deemor) has legal authority to revoke the trust and then to use the funds to meet his food or shelter needs, or if the individual can direct the use of the trust principal for his/her support and maintenance under the terms of the trust, the trust principal is a resource for SSI purposes." POMS SI 01120.200D.1.a.

3. The Medicaid trust rules are somewhat different:

   a. Generally, trust income and principal would be considered to be “available” if either the income or the principal under any circumstances could be used for a particular purpose.

   b. Much more flexibility is available for third party created trusts.

   c. Self-settled trusts, whether created by the individual or his or her spouse, someone with authority to act on behalf of the individual (i.e., under a power of attorney), or a court or administrative body, will give rise to particular transfer penalties, depending on whether the trust is revocable or irrevocable, and when distributions are made from the trust to third parties other than the creator.

   d. In the case of third party created trusts, it is generally safer to avoid criteria such as “support” or “health” and instead to refer to specified “special needs” or “supplemental care” criteria and to include very clear and specific language that the beneficiary’s needs-based benefits shall not be affected by trust distributions.

4. Self-settled trusts will generally be considered available for SSI purposes unless created prior to January 1, 2000, in which case such grandfathered trusts, if irrevocable and discretionary, in most cases will not be considered to be available until funds are distributed.

5. “Supplemental needs" (d)(4)(A) trusts for disabled persons under age 65, and (d)(4)(C) “pooled trusts” for disabled persons of any age, are exempted for both Medicaid and SSI purposes.

a. “Payback” is required if the disabled person’s assets are used to fund these trusts, and persons over 65 who fund a pooled trust will incur a Medicaid and SSI transfer penalty.

b. A (d)(4)(A) or “under 65" trust may be created using the disabled person’s own assets by certain persons other than the disabled person (such as a parent or the court), while the disabled person himself or herself may transfer his or her own assets to a (d)(4)(C) or “pooled trust,” subject to transfer penalty implications if an individual’s own assets are transferred to a pooled trust and the individual is 65 years of age or older.

B. For “needs-based” benefits, “income” is cash, or anything that can be used for food or shelter.

1. As will be noted later, "income" for SSI purposes is not the same thing as "taxable income" for income tax purposes.

2. "Income" for SSI purposes includes in-kind support and maintenance ("ISM"), which includes providing for food or shelter either directly or indirectly rather than providing cash that can be expended for food or shelter.

3. Clothing was included as an item of in-kind support and maintenance until March 9, 2005, when the Social Security Administration published final regulations amending the income and resource rules for the SSI Program. Consequently, a special needs trust can now purchase clothing without being deemed to have provided ISM.

C. Income for tax purposes requires an entirely distinct analysis.

1. “Taxable income” for trust beneficiaries, can either be a direct distribution to a beneficiary or payments made to another person for the benefit of the beneficiary.

a. E.g., if the trustee of an SNT pays the telephone bill of the beneficiary out of trust income, the beneficiary has received a benefit and will be deemed to have received “taxable income.”

b. The beneficiary did not receive “income” for benefits purposes because the beneficiary received neither cash nor food or shelter.

2. An SNT that is the designated beneficiary (“DB”) of a retirement plan or account will be subject to the trust income rules found in I.R.C. §§ 641, *et seq*.

a. Ordinary income not distributed is taxed at compressed rates (for 2010, 35 percent after only $11,200 of income).

b. If the DB received the retirement proceeds directly, the highest bracket of 35 percent in 2010 for both single and married taxpayers filing jointly would not be reached until the beneficiary received $373,650.

c. A trust which is not a "grantor trust" is treated as a separate tax entity and discretionary distributions of income pass through to the beneficiary to the extent distributed.

3. After death of the participant, distributions of qualified dollars are generally taxed as income in respect of a decedent ("IRD"), taxed to the beneficiary when received, with taxation being accelerated if the right to receive the income is transferred by the beneficiary or the decedent's estate.

a. IRD distributions from retirement plans are considered wholly or partially distributions of principal for trust accounting purposes, while for income tax purposes distributions are considered income.

b. To avoid problems, the trust should allow the trustee to distribute discretionary amounts of income and principal to avoid trapping the income at the trust level and subjecting the distributions to higher tax rates. However, this would be problematic in the case of a (d)(4)(A) or (d)(4)(C) trust which must be established for the "sole benefit" of the disabled beneficiary and which may require the accumulation of income to preserve benefits.

c. PLR 200620025 lays the groundwork to show how inherited IRAs can be transferred to trusts during lifetime. The IRS held that transferring an inherited IRA to a grantor trust will neither (i) be considered a sale or exchange resulting in the immediate recognition of income, nor (ii) result in taxable income being triggered under I.R.C. §691(a)(2). Further, the IRS ruled that the required minimum distributions, as described under I.R.C. §401(a)(9), paid to a trust for the benefit of a disabled beneficiary, are to be calculated using the disabled beneficiary's age.

4. If the expected needs of the SNT beneficiary are less than the minimum required distribution ("MRD") from the retirement plan or account, then the SNT may not be the most desirable beneficiary.

a. Distributions to avoid tax at the trust level may eliminate eligibility for SSI and Medicaid.

b. Distributions not made will be taxed at the trust level at compressed rates.

c. In such cases, the retirement plan might better be payable to a beneficiary who is not disabled and for other assets, such as insurance, to be paid or distributed to the SNT.

d. If there are other beneficiaries in addition to the disabled beneficiary, then the IRD distributions may be distributed to the non-disabled beneficiary as a means of avoiding tax without affecting the disabled beneficiary's eligibility for SSI or Medicaid.

5. Life insurance is an excellent funding vehicle for a special needs trust because of the absence of income tax and Indiana inheritance tax consequences.

6. Consider including the following provisions in special needs trusts, and in particular first party or "self-settled" trusts:

   a. Include language prohibiting the beneficiary from terminating the trust.

   b. Do not include language in a self-settled special needs trust permitting the termination of the trust by the trustee or anyone during the lifetime of the beneficiary, to avoid the problem of allowing payments to a third party other than the beneficiary, thus violating the "sole benefit" requirement for special needs trusts.

   c. The trust must be administered properly, as well as being properly drafted and funded. Improper distributions from a properly drafted and funded trust can cause the loss or reduction of public benefits. See the comments which follow regarding "In-Kind Support and Maintenance" and the presumed maximum value rule.

   d. A "spendthrift clause" is advisable, since if a beneficiary can sell his or her beneficial interest in the trust, the interest would be treated as a resource. POMS SI 01120.200D.1.a.

   e. Since there appears to be no federal restriction on naming a family member as contingent beneficiary of the guaranteed portion of a structured payment upon the death of the primary beneficiary, then unless state law precludes doing so, it may be possible to avoid a payback to the Medicaid program since the structured payment would then be paid to the family member and not to the trust. Consider purchasing a commutation rider to provide funds to pay any applicable taxes.

f. The payback is not limited to Medicaid expenditures made after the trust was established, and if more than one state has made payments, the funds remaining in the trust may be required to be paid pro rata. POMS SI 01120.203B.1.h.

g. Taxes due from the estate of the beneficiary, other than those arising from the inclusion of the trust in the estate and inheritance taxes due for residual beneficiaries, are not permitted prior to reimbursement of the state for medical assistance. POMS SI 01120.203B.3.b.

h. Use the words "for the sole benefit of" in the self-settled special needs trust document.

i. For an additional discussion of SSI implications of particular trust provisions, see John J. Campbell, *Basic Strategies for SSI Planning* (NAELA Journal, Volume 1, 2005), 311, *et seq*.

VI. Consequences of Distributions for Benefit Purposes.

A. Supplemental Security Income (“SSI”) is a federal program administered by each state to provide a minimum level of monthly income. See 20 C.F.R.416.101, *et seq*.

1. Title XVI of the Social Security Act specifies who is eligible, the amount of cash payments, and the conditions under which payments can be made.

2. The purpose of the SSI program is to provide a basic level of income. If you are receiving income from another source, your SSI benefit will be cut dollar for dollar. While the SSI program’s benefits are meager, in most states SSI recipients are automatically eligible to receive Medicaid. SSI recipients will also be eligible for food stamps in most states and in some cases for special programs for the developmentally disabled.

3. In most states SSI recipients are categorically eligible for most other essential needs-based public benefits, including Medicaid.

a. Eligibility for SSI does not automatically qualify a beneficiary for Medicaid in so-called § 209(b) states, such as Indiana, but the rules for obtaining Medicaid eligibility are very similar to the SSI rules.

b. Most of the comments in this section of this outline will focus on SSI eligibility with distinctions concerning Medicaid being addressed in a few areas.

4. SSI is a “needs-based” benefit requiring disability and imposing resource and income limitations.

a. Recipient must be age 65 or older, blind, or disabled, and have income and resources within specified limits.

b. The resource test establishes eligibility; income test determines the size of the benefit that the recipient will receive.

5. The SSI amount is set annually at the federal level and supplemented by certain states (but not Indiana) to meet basic needs for food and shelter.

a. "Income" is anything an individual receives in cash or in kind that can be used to meet the individual's needs for food and shelter.

b. In 2010, the maximum SSI benefit is $674.00, without a state supplement adjustment, which is expected to cover food and shelter ($1,011.00 for a couple).

6. Receipt of anything not specifically exempted which can be applied, either directly or indirectly, by sale or conversion, to meet basic needs of food and shelter, will be treated as income.

a. Since there is no specific exemption for a boat, receipt as an inheritance would result in assumption that it could be sold or converted and the value would count as income in the month that it is received.

b. For every dollar more than (i) $20 per month of "unearned income" paid to an SSI recipient, and (ii) one-half of earned income above $65 per month, his or her benefits will be reduced dollar for dollar.

c. Unearned income includes cash from any source as well as assets which are not exempted, and can include other benefits (such as Social Security Disability).

d. Cash paid directly from the trust to the individual will always count as income and will reduce the SNT beneficiary's benefits dollar for dollar.

7. A trustee's payment to a third party not providing a disabled beneficiary with food or shelter does not cause disqualification or diminution of benefits.

a. Payment of an individual's bills (including supplementary or other medical insurance premiums) by the trust directly is not income, unless the payment results in the beneficiary receiving an asset as a result of the payment that can be used for food and shelter.

b. A payment for food or shelter is countable income called "In-Kind Support and Maintenance" ("ISM").

c. Receipt, or the right to receive, ISM (i.e., actual food and shelter), will result in a reduction of SSI benefits on a dollar for dollar basis, up to a presumed maximum value ("PMV").

d. The PMV is the limit on the amount of ISM that can be charged.

e. Any food or shelter received is presumed to be worth a maximum value.

f. The amount of the PMV is equal to one-third the federal benefit rate ("FBR") in effect for the month in which ISM is received for an individual or an eligible couple, plus $20 (unless the $20 disregard has already been applied to an unearned income payment).

g. The PMV rate for the year 2010 is $225 (plus $20 if applicable for an increase to $245 if the $20 disregard has not been applied).

h. The PMV rule allows a trustee discretion to make distributions for shelter costs with the result that paying the beneficiary's rent will cause a reduction of the beneficiary's SSI by not more than $225 per month.

i. I.e., if an SNT receives a $12,000 retirement distribution and pays the SNT beneficiary's rent of $1,000 per month directly for the full year, the trust has no retained income and the beneficiary would receive $12,000 of taxable income for the entire year; for SSI purposes, however, the PMV is limited to $245, less the disregard, if applicable, for the particular month, and if the beneficiary was receiving $674 per month, the beneficiary's benefits would be reduced to $449 ($674 - $225 = $449). Note, however, that prepayment of rent, particularly if refundable, may be deemed to give rise to a resource, and even if acceptable for SSI purposes, may be treated as a resource for Medicaid purposes.

j. If the actual value of the ISM is less than the PMV, only the actual value is counted as ISM. For example, if a third party pays the household's electric bill, which was $100, only $100 is counted as ISM. The $100 amount is divided equally among all the household members. If the household has four members, only $25 of ISM is counted for the SSI eligible individual.

k. Refer to POMS SI 01120.200F and SI 00835.901.

8. Trust ownership or purchase of home:

a. If the trust is not a resource for SSI purposes, and purchases and holds a residence as a home for the beneficiary, the residence is not a resource to the beneficiary, nor would it be a resource if the beneficiary moves from the house. The trust holds legal title and, therefore, the beneficiary is considered to be living in his/her own home based on having an "equitable ownership under a trust." If the trust is a resource to the individual, the home is still subject to exclusion.

b. A beneficiary does not receive In-Kind Support and Maintenance ("ISM") in the form of rent-free shelter while living at home in which he/she has an ownership interest. Payment of rent by the beneficiary will not affect his/her SSI payments.

c. Since purchase of a home by the trust establishes an equitable ownership for the beneficiary, the purchase results in receipt of shelter in the month of purchase that is income in the form of ISM which will be valued at no more than the PMV.

d. Even though the beneficiary has an ownership interest, and if living in the home, does not receive ISM in the form of rent-free shelter, purchase of the home or payment of the monthly mortgage payment by the trust is a disbursement from the trust to a third party that results in the receipt of ISM in the form of shelter.

e. If the trust, which is not a resource, purchases the home outright and the individual lives in the home in the month purchased, the home would be income in the form of ISM and would reduce the individual's payment by no more than the PMV in the month of purchase only, regardless of the value of the home.

f. If the trust, which is not a resource, purchases the home with a mortgage and the individual is living in the home in the month purchased, the home would be ISM in the month of purchase. Each of the subsequent monthly mortgage payments would result in the receipt of income in the form of ISM to the beneficiary living in the house, each valued at no more than the PMV.

g. If the trust pays for other shelter or household operating costs, these payments would be income in the form of ISM in the month of payment.

h. If the trust pays for improvements or renovations to the home (e.g., renovations to the bathroom to make it handicapped accessible or installation of a wheelchair ramp, or assistance devices, etc.), the individual does not receive income. Disbursements from the trust for improvements increase the value of the resource, and unlike household operating expenses do not result in ISM.

i. For additional information, refer to POMS, SI 01120.200F.

9. Although SSI criteria in the case of SNTs may be more restrictive than the Medicaid criteria, *Ramey v. Rizutto*, 72 F.Supp.2d 1202 (D.C. Colo. 1999), aff'd *Ramey v. Reinertson*, 268 F.3d 955 (10th Cir. 2001), held that an individual who is eligible for SSI under the federal social security regulations cannot be denied Medicaid benefits by the application of more restrictive state laws or regulations.

VII. Indiana Medicaid Income Differences.

A. Indiana generally follows the federal SSI definitions with certain deductions and exclusions which may include:

1. All earned income of a child under 14 is excluded.

2. Up to $10 of defined irregular or infrequent income is disregarded if the total amount of irregular or infrequent income earned in a month does not exceed $10.

3. Expenses allowed to be deducted from gross income from self-employment to determine self-employment earnings under IRS rules are deducted for Indiana Medicaid purposes.

4. Earned income of $65 per month, plus impairment related work expenses for individuals in the disabled category, plus one-half of the remaining earned income, is excluded.

5. Funds from rents, scholarships, or fellowships, for tuition and mandatory books and fees at an educational institution or for vocational rehabilitation or technical training shall be deducted.

6. Tax refunds are excluded.

7. Home energy assistance is disregarded.

8. Up to $20 of unearned income is disregarded if infrequent or irregular, as long as income does not exceed $20.

9. A general income disregard of $15.50 is deducted each month. In the case of a categorically blind Medicaid recipient, certain income specified in an approved plan for self-support is disregarded.

10. If the Medicaid recipient is under age 18 and living with his or her parents, the parents' income is included unless the recipient has been approved for home and community-based services under an approved waiver which specifies the exclusion of parental income.

11. A "spend down" applies for medical expenses which equal or exceed the excess income.

12. Loans will generally not be considered as income, but after the month of receipt, may be treated as a resource.

13. Payments from contract sales of property, less expenses of ownership, are counted as unearned income.

14. ISM applies (defined as any food or shelter received by the recipient and his or her spouse, or by the child applicant or recipient and his or her parents because someone pays for it). For this purposes, shelter means room, rent, mortgage payments, real property tax, heating, fuel, gas, electricity, water, sewerage, and garbage collection services.

15. ISM shall be considered as unearned income and shall be the actual value of the food or shelter received, not to exceed one-third of the applicable Indiana income standard.

16. ISM for shelter or food shall not be considered if the applicant or recipient and his or her spouse or his or her parents, if he or she is a child, live in someone else's household and pay a pro rata share of shelter or food.

B. The Indiana income standards will increase annually in the same percentage amount that is applied to SSI benefits under 42 U.S.C. 1382(f).

C. See 405 IAC 2-3-3, *et seq*.

Special Needs Trust Drafting and Administration Issues.

A. Including POMS Provisions in the Trust Documents.

1. Many trustees are clueless about the proper management of SNTs.

2. Including specific instructions may help.

3. Including provisions in the trust agreement that direct the SSA staff to the 8 - Step Action Chart in the POMS at SI01120.203D.1 can be helpful in assuring a favorable review and approval of the special needs trust by SSA.

B. The trust should state that the trustee is to consider the best interest and needs of the disabled person over all others, including the Medicaid program.

1. Trustee should be clearly advised that its sole responsibility is to do what is in the best interest of the principal beneficiary.

2. Trustee should be encouraged in the trust document to employ social workers, attorneys, and other experts to aid the trustee in proper management of the trust.

3. Alert trustee to the need to purchase pre-need funeral services and burial plots (possibly through actions of a guardian or attorney-in-fact and using other available assets), and to avoid the "stinking dead body rule" if applicable.

4. Include an escape hatch to amend the trust to conform to its purposes and changes in the law. Given the lengthy appeals process, it may make sense to amend the trust to conform to SSA's demand rather than to appeal, or to amend and file a new application.

5. Trustee and others should be advised of the SSI recipient's duty to report any changes in income, resources, living arrangements or other conditions pursuant to 20 CFR § 416.708. Failure to report is fraud and may result in criminal or civil penalties.

6. Trustee should assess and be aware of the following issues concerning the beneficiary and the beneficiary's family:

   a. Financial sophistication in general and willingness to follow sole benefit requirements of SNTs.

   b. Unrealistic expectations of financial returns and ability to deal with investment risks.

   c. Beneficiary and family credit history problems.

   d. Extent of medical involvement - how sick is the beneficiary?

   e. Existence of other resources to support the family and the beneficiary.

7. All distributions should be made with knowledge and awareness of the income and resource implications.

C. The family may consider giving special instructions to the trustee for guidance in the administration of the trust for the principal beneficiary.

1. Does the beneficiary sign some checks, control certain funds, complete bank deposit slips, etc., and precisely how much help does the beneficiary need with money management?

2. What kind of living conditions is the beneficiary accustomed to?

    a. Does he/she require or expect his/her own bedroom?

    b. Is he/she used to a particular kind of bed or mattress?

    c. What kinds of appliances and/or entertainment mechanisms should he/she have (e.g., color TV with remote, VCR/DVD recorder and player, stereo, radio, telephone, computer, video games, golf clubs, bowling ball)?

    d. Does he/she help with the daily or periodic chores, such as making his/her bed, some cleaning, cutting the lawn, shoveling snow, etc.?

    e. What are his/her practices and how much help does he/she need in the area of personal hygiene?

3. What specific medical issues need to be addressed, such as medications that he/she takes and who are his/her medical providers?

4. Is he/she employed and what are his/her work capabilities?

5. What foods does he/she like and what are his/her eating habits?

6. Does he/she like to travel, and what are his/her entertainment preferences?

7. Is he/she able to vote, and if so, how much assistance does he/she need?

8. What are his/her funeral preferences?

9. Are there any eccentricities that should be considered?

D. Tax issues in the planning and administration of special needs trusts.

1. Whether the trust is set up by a third party or whether it is self-settled, it will typically be a separate taxpayer requiring a taxpayer identification number and the trustee will be required to file fiduciary income tax returns.

2. If it is a non-grantor trust for income purposes, it typically will not be a "simple trust" because it is generally not advisable to require the distribution of all income to or for the benefit of the beneficiary each year. The trustee will generally have discretion whether or not to distribute the income.

Consequently, SNTs are usually either complex trusts or grantor trusts for income tax purposes.

3. While a third party SNT is usually treated as a “complex trust” for income tax purposes, a self-settled SNT is generally a grantor trust for income tax purposes.

   a. With a grantor trust, social security number of the beneficiary may be used rather than tax number for identification.

   b. The income generated by a grantor trust is taxed to the grantor.

   c. All of the income earned by the SNT, whether distributed to the grantor or not, will be reported as income to the grantor on the grantor’s individual federal and state returns.

4. Where a grantor is treated as the owner of the trust and the trustee is not the grantor, then the trustee may choose between two approaches for tax reporting:

   a. Furnish the name and social security number of the grantor, and the address of the trust, to all those who pay income to the trust, or hold accounts for the trust, and obtain an executed Form W-9 from the grantor; or

   b. Furnish the name, address and tax identification number of the trust to all who pay income to the trust or hold accounts for the trust who or which will issue an IRS Form 1099 showing the income or gross proceeds received by the trust, file an IRS Form 1041 and corresponding state income tax return which does not show the income, but which has an attached statement showing the name, address and social security number of the beneficiary and the grantor and the amount of income, deductions and credits.

5. Generally, and as noted previously, the practical result of undistributed income if the SNT is not a grantor trust is usually an increase in the income tax liability because of the compressed trust tax rates.

   a. If the SNT is treated as a grantor trust, then the income will be taxed at the grantor’s own tax rates, which will generally be lower than the rates applicable to trusts.

   b. A non-grantor trust which is not required to meet the requirements of 42 U.S.C. §1396p(d)(4)(A) or (C) may also provide for other beneficiaries as permissible distributees of the income.

6. IRC §642(b)(2)(C), enacted by the Victims of Terrorism Tax Relief Act of 2001, PL. 107-134, §116(a), provides that a “qualified disability trust” is allowed a personal exemption equal to the IRC §151(d) personal exemption for an individual.

   a. A qualified disability trust is any trust that meets the requirements of 42 U.S.C. §1396p(C)(2)(B)(iv), and as of the close of the tax year the trust must be established for the sole benefit of a person under age 65 who must be disabled within the meaning of §1614(a)(3) of the Social Security Act, 42 U.S.C. §1382(c)(a)(3), for some portion of such year.

   b. A trust shall not fail to meet these requirements merely because the corpus of the trust may revert to a person who is not so disabled after the trust ceases to have any beneficiary who is so disabled.

   c. To maximize these benefits, it is important to give the trust as much discretion as possible to allocate distributions of income and principal for the beneficiary in order to take advantage of the beneficiary’s personal exemptions and standard deduction amounts.

   d. Treas. Reg. § 1.643(a)-3 allows the trustee flexibility to allocate capital gains to income, the only restriction being consistency. Any distribution of principal made during the year would carry out the excess capital gain of the beneficiary which can be excluded from tax through the personal exemption and/or the standard deduction.

   e. For these arrangements to work, the grantor trust rules must be avoided.

   f. Qualified disability trust status confers the power to accumulate $3,650 every year (as adjusted each year after 2010) in the trust tax-free, and additional expenses that the parents may be paying out of their own funds can then be paid for by the trust and are treated as carrying out income to the beneficiary. To the extent that expenses paid by the beneficiary qualify for medical expenses, further income tax reduction is possible.

   g. See Sherman, "The Overall Tax Impact of Accumulating Versus Distributing Trust Income," Estate Planning, Vol. 27, No. 3, (February 2001).

7. For income tax purposes, the grantor of a trust may be the beneficiary who furnished the trust funds in a self-settled trust, who may not necessarily be the individual named as the grantor in the trust agreement.

a. For example, a self-settled trust for a beneficiary of a negligence award may be created by that beneficiary's parents for the beneficiary.

b. Although a parent may be called the grantor in the trust agreement, if the funds of the trust were contributed by the beneficiary, the grantor trust rules would apply to the beneficiary who funded the trust.

8. When creating self-settled trusts, practitioners often include provisions to have the trust treated as a grantor trust:

a. The power to reacquire the trust corpus by substituting property of an equivalent value pursuant to IRC §675.

b. Where income is distributed to the grantor or the grantor's spouse or held to accumulate for future distributions to the grantor or the grantor's spouse without approval or consent of any adverse party pursuant to IRC §677(a).

c. An unrestricted power to remove or substitute trustees and to designate any person, even one related to or subordinate to the grantor, as a replacement trustee pursuant to IRC §674, Reg. Sec. 1.674(d)(2).

d. Other grantor trust provisions may be found in IRC Sections 673, 674, 675, 676 and 677. Some of these provisions, such as the power to revoke the trust, would not be appropriate for a self-settled SNT.

9. The income tax grantor treatment may be different then the estate tax treatment.

a. The mere fact that the grantor is subject to income tax on the income does not necessarily require inclusion in his or her estate for estate tax purposes.

b. For estate tax purposes, there is no absolute correlation between the income tax and estate tax aspects of the grantor trust rules.

c. Likewise, if a third party SNT is created for the benefit of a disabled beneficiary, funds placed in that trust may be subject to gift tax and may not be eligible for the gift tax annual exclusion because the transfer involves a gift of a future interest. However, if the third party grantor who creates or funds a trust retains a power of disposition of the trust assets (such as a testamentary limited power of appointment over the remainder interest), the transfer may be considered an incomplete gift (see Treas. Reg. §25.2511-2(b) and PLR 9437034).

10. If a parent establishes a third party special needs trust and is designated as the trustee, and retains the power to accumulate income for the child's benefit, or if distributions will be made at the parents' discretion which is not covered by an ascertainable standard, the trust assets would be taxed in the parents' estate for federal estate tax purposes.

    a. A reserved power to substitute other property of equal value for property already held in the trust would make the trust a grantor trust for income tax purposes, but since it is not a power to alter, amend or revoke, it does not make the trust includable for estate tax purposes. Rev Rul 2008-22, 2008-16 IRB 696, establishes that the corpus of an irrevocable trust that a grantor created during life is not includable in his or her gross estate under IRC §2036 or IRC §2038 on account of the grantor having retained the power, exercisable in a non-fiduciary capacity, to acquire property held by the trust by substituting other property of equivalent value.

    b. Although certain types of economic control over the trust may make the trust income taxable to the grantor, the trust itself is not, on that ground alone, includable in the grantor's estate for estate tax purposes.

E. Other trust provisions.

1. Trust protector - consider designating a person with authority to remove and replace the trustee if the trustee is not adequately discharging fiduciary duties.

2. The trust should not direct that distributions be made for support, health or maintenance of the beneficiary; likewise, discretionary support provisions are inappropriate.

    a. Some practitioners use fully discretionary language with the precatory special needs language.

    b. Some practitioners use a fully discretionary trust but prohibit distributions for food and shelter. In light of the uncertainty of the future needs of the beneficiary, this may be overly restrictive in some states.

    c. Some practitioners use a fully discretionary trust that specifically authorizes the trustee to provide in-kind support if the trustee deems that the beneficiaries needs will be better met with a distribution in spite of the partial reduction in SSI benefits or Medicaid due to the PMV rules.

d. The following Medicaid rules apply in the State of Indiana for trusts established after the effective date of OBRA 1993 (August 11, 1993):

Trusts established with the assets of the Medicaid applicant/recipient or his or her spouse, unless established pursuant to a last will and testament, will be subject to the rules set forth in ICES Manual §2615.75.20.

Pursuant to ICES Manual §2615.75.20.10, trusts established on or after August 11, 1993 that are not governed by OBRA 1993 must be reviewed for the purpose of determining the "availability of the trust." This would include trusts created by will (i.e., testamentary trusts), or by a third party other than a spouse or someone acting in behalf of the applicant/recipient and funded with the assets of another person. In general, if funds from the trust can be distributed, then they will be presumed to be available.

1. Spendthrift provision - the trust should contain a provision protecting the trust assets from the claims of the beneficiary's creditors.

   a. Since a (d)(4)(A) SNT is funded with the assets of a disabled beneficiary, it is a question of state law whether the spendthrift provision will be effective against the beneficiary's creditors other than the state Medicaid program.

   b. However, for public benefits purposes, the SNT with a spendthrift provision will be effective for SSI and Medicaid purposes by virtue of the specifically applicable statutory provisions.

2. Authorizing trustee compensation and payment of fees, taxes and administrative expenses.

   a. Indiana Senate Bill No. 301, effective July 1, 2009, added I.C. 30-4-3-25.5, which applies beginning October 1, 2009.

   b. Except for federal and state taxes, the trustee of a trust created to comply with 42 U.S.C. §1396(p)(d)(4)(A) shall not distribute trust property to any person entitled to payment from the trust until the Office of Medicaid Policy and Planning has been fully reimbursed for assistance rendered to the person for whom the trust was created.

   c. Consequently, accrued and unpaid fees as well as reimbursement for expenses advanced, which might be reimbursable prior to the death of the beneficiary, may not in fact be properly payable after the death of the beneficiary.

3. Amendment by the trustee or court as necessary to comply with applicable federal and state laws, regulations and policies concerning SNTs.

4. Depending on the desirability of doing so, drafting the trust as an intentionally defective grantor trust, or avoiding grantor trust status in order to meet the qualified disability trust requirements of I.R.C. § 642(b)(2)(C).

F. Fraudulent transfer and related issues.

1. Although this presentation will not address such issues in any significant way, planners should consider the following:

a. I.C. 32-18-2-14, concerning transfers deemed to be fraudulent as to present and future creditors.

b. I.C. 31-16-17-1, concerning a child's duty to furnish support for parents.

c. I.C. 35-43-5-7, relating to certain criminal violations for welfare fraud.

2. Related issues of which planners need to be aware:

a. Voluntarily assuming liability: Pursuant to the federal guarantor prohibition under the Nursing Home Reform Act, 42 U.S.C. §§1395i-3(c)(5)(ii), 1396r(c)(5)(ii), facilities certified for Medicare or Medicaid payments may not include a financial guarantee as a condition of admission or continued stay.

b. A child or other person may be liable for a breach of fiduciary duty (i.e., if a guardian or attorney-in-fact fails to apply funds to the obligations of the protected person or misappropriates funds).

c. Beware of conflicts of interest which may give rise to claims for breach of fiduciary duty.

G. Trust Approval.

1. The trust should be submitted to the SSA for approval. SSI recipients are under a continuing duty to report any changes in their income, resources, living arrangements, or other conditions to the SSA. 20 C.F.R. § 416.708. Consider including the following:

a. Client's name and social security number.

b. Receipt of personal injury settlement, inheritance, or other funds, including copies of relevant documents and the trust agreement, as well as bank statements showing deposit to the trustee's account and any disbursements to date.

c. Also include the SSA's POMS sections on trusts and containing the eight-step action charts to help the claims representative in analyzing the trust, all of which should be submitted with supporting documents by certified mail (see POMS SI 01120.203).

d. Letter and supporting documents should be sent to the local SSA office providing services to the client or to the SSA district office pertaining to the representative payee, if there is a representative payee.

e. SSA will probably not send a letter approving the trust, but would definitely send a notice if the trust is not approved.

f. The trust should also be submitted to the state Medicaid agency in the case of a self-settled special needs trust.

Estate Recovery.

For the federal law requirement that states assert claims against a recipient's probate estate, and allows the states to assert claims against various types of non-probate transfers, see 42 U.S.C. §1396p(b).

Indiana allows a preferred claim against the estate of a Medicaid recipient for any Medicaid benefits received after age 55. I.C. 12-15-9-1.

Indiana has adopted an expanded estate definition. I.C. 12-15-9-0.5(a)(2).

There is a nine month time limit within which to make such a claim against non-probate transfers. I.C. 12-15-9-0.6.

As of July 1, 2005, I.C. 12-15-9-1(a) was amended to allow recovery against the estate of the deceased Medicaid recipient's spouse following the spouse's subsequent death.

However, some court cases have held that such statutes conflict with federal law. See *Hines v. Department of Public Aid*, (Ill. No. 100841, May 18, 2006).

Nevertheless, the Oregon Court of Appeals has held that the State of Oregon may retroactively apply an estate recovery statute against a life estate created before the adoption of the statute, although the case was decided merely on the basis of the trial court having erred in granting summary judgment. *State of Oregon v. Jack Willingham*, State of Oregon Court of Appeals, May 31, 2006 (Number 0308-08747; A126258).

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