

Special Needs Trusts: Planning Vehicles That Have Come Of Age

Special needs trusts (SNTs) are conceptually simple – however, their creation and administration can be highly complex. This article points to the technical and practical issues professionals need to consider as they counsel beneficiaries and their families to make informed decisions about using SNTs.

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Introduction

Little doubt can remain that special needs trusts (SNTs) have truly come of age as viable planning vehicles for recipients of public assistance programs. Not only can they preserve financial eligibility for programs such as Medicaid and Supplemental Security Income (SSI), but they can also dramatically improve the quality of life for recipients of those programs.¹ While still technical and complex in nature, what was once a very arcane area of the law is now better understood by greater numbers of professionals and has been the subject of much secondary literature.

While this article will be somewhat technical by necessity, it will emphasize the practical aspects of creating and administering SNTs to the greatest extent possible. In emphasizing these practical aspects, the article will provide an overview of SNTs and the utility of their use for those readers who have less experience or familiarity with the topic. The article will then examine the specialized duties of a SNT trustee and will explore some of the potential tax

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consequences of establishing SNTs as well as some more traditional fiduciary duties such as accounting and investing. Last, the article will consider several unique ethical dilemmas that are frequently presented in the administration of a SNT.

As a final note to this introduction, the article assumes that a potential SNT beneficiary's disability or level of care is not at issue in determining eligibility, and will therefore only be considering the financial aspects of eligibility for public assistance programs.

A Special Needs Trust Overview

Despite the complexity presented by SNTs, they are premised on two very simple and understandable principles. The first principle is that assets held in traditional trusts will generally be counted as an available resource when someone applies for most means tested public assistance programs. Counting trusts as an available resource can make things very difficult for individuals and their families who want to plan for the extraordinary costs associated with providing for special needs.

The second principle is that SNTs provide a very narrow exception to this general rule that normally applies to traditional trusts. A properly drafted and administered SNT will not be counted as an available asset, and proper trust distributions will not be counted as income.

To qualify for the narrow exception afforded by SNTs, however, the trust must meet certain statutory requirements and subsequently pass review by the Social Security Administration (SSA) or the state agency responsible for administering the trust beneficiary's public assistance program.² Assuming these conditions are met, a SNT holds the potential to prevent individuals from having to impoverish themselves as a prerequisite to receiving public assistance for their basic care. This potential to protect assets applies equally to inheritances from family members, insurance proceeds, personal injury settlements, or any other asset that may come into the individual's possession and therefore jeopardize eligibility.

The specific type of SNT that is appropriate to use will depend on the facts and circumstances of each situation. Without regard to the type of trust ultimately used, however, all SNTs share a unique characteristic that holds great potential for public assistance recipients. While various planning tech-

niques exist for creating or maintaining program eligibility, SNTs are one of the few techniques that also establish a fund that is available for supplementing the basic care provided by public assistance.

Types of Special Needs Trusts

Briefly, two broad distinctions may be drawn among all SNTs. Every SNT will be either a "Third Party Special Needs Trust" (Third Party SNT) or a trust created pursuant to the provisions enacted into law by the Omnibus Budget and Reconciliation Act of 1993 (OBRA 93).³ You may initially determine whether a Third Party SNT or an OBRA trust would be more appropriate by looking at the source of the assets that will be used to fund the trust. If the funding assets do not belong to the potential beneficiary, or deemed to belong to the potential beneficiary, then a Third Party SNT is generally the most appropriate vehicle.

As will be explained below, there is a significant reason for using a Third Party SNT when the beneficiary has no ownership interest in the funding assets. In contrast to a Third Party SNT, an OBRA trust must be used when the potential trust beneficiary has an ownership interest in the funding assets. In turn, OBRA trusts may be distinguished from one another according to the statutory requirements found in 42 U.S.C. § 1396p (d)(4)(A) or (d)(4)(C). Trusts created pursuant to (d)(4)(A) are sometimes referred to as disability trusts,⁴ while trusts created pursuant to (d)(4)(C) are referred to as pooled trusts.

Disability Trusts

To meet the requirements for a disability trust, the beneficiary must be under age 65 and be disabled as defined by law.⁵ Also, the beneficiary's parent, grandparent, legal guardian, or a court may only establish the trust. It must also be established with the beneficiary's assets and administered for the sole benefit of the beneficiary.

As we will see later in the article, the implications of this "sole benefit" requirement can become a complicating factor in the administration of a SNT. Regarding the final statutory requirement, the trust document must have a "payback" provision that becomes effective at the beneficiary's death or termination of the trust. This payback provision requires the trustee to use any remaining trust assets to reimburse each state where the beneficiary received public assistance up to the extent of each state's

proportional share of assistance provided. Because of this payback requirement, a disability trust should not be used when the beneficiary has no ownership interest in the funding assets.

A Third Party SNT should be used when someone other than the beneficiary owns the funding assets because no payback provision is required. Without this payback provision, the grantor who funded the trust is free to direct how the assets will be distributed at the beneficiary's death.

Pooled Trusts

While pooled trusts are significantly different from disability trusts, they do share some similarities. For example, the beneficiary of a pooled trust must be disabled as defined by 42 U.S.C. § 1382c(a)(3) just like the beneficiary of a disability trust. Another similarity is that the trust account must be established and administered for the sole benefit of the beneficiary.

Beyond these similarities, however, the differences can sometimes become confusing. For example, the beneficiary's parent, grandparent, legal guardian, or a court must establish a pooled trust account just as with disability trusts. Unlike disability trusts, however, the requirements for pooled trusts expand this grantor class by allowing the individual trust beneficiary to establish a trust account on his or her own behalf. Also unlike disability trusts, the beneficiary of a pooled trust does not need to be under age sixty-five or meet any other age requirement.

A number of fundamental distinctions may be drawn between pooled trusts and disability trusts, and the term 'pooled trust' is a good entry point for examining these distinctions. As the term implies, a pooled trust consists of multiple trust accounts that are pooled for investment and management purposes. By contrast, there is no such requirement imposed on disability trusts. Another significant distinction is that pooled trusts must be established and managed by a non-profit association. The non-profit pools the funds of many beneficiaries for investment and management but is required to keep separate accounts for each beneficiary.

Perhaps the most distinguishing characteristic, however, is that pooled trusts have a modified payback provision. Unlike disability trusts, which must have an absolute payback provision, the pooled trust may retain any assets remaining in a beneficiary's trust account at that beneficiary's death.

However, any assets not retained within the pooled trust must be used to reimburse each state where the beneficiary received public assistance up to the extent of each state's proportional share of assistance provided.

The Utility of Establishing a Special Needs Trust

Although the utility of a SNT is almost intuitive, the following example will better illustrate the considerable difference that can be realized in the life of a public assistance recipient. In our example, Robert Smith is a fifty-four-year-old single male who was seriously injured in an automobile accident three and a half years ago and is about to receive a \$450,000 net settlement. While he is now paraplegic and resides in a nursing home, he hopes to be able to leave the nursing home within the next year and will be purchasing a specially equipped house, a handicapped van, and a specialized wheelchair.

If he is able to leave the nursing home, Robert expects to spend \$30,000 annually on his living expenses, or \$2,500 monthly, which does not include any of the major costs specifically associated with his special needs. He receives a monthly Social Security Disability Income (SSDI) payment of \$950 because he worked a sufficient number of quarters prior to the accident. He also receives Medicare because he has been receiving SSDI for a period of twenty-four months.

In addition to his SSDI and Medicare, Robert is eligible for Medicaid. Medicaid currently provides a maximum monthly benefit of \$3,300 for his room and board at the nursing home, \$1,250 for his medications, and \$1,000 for his physical therapy. In the state where Robert resides, all but \$35 of his income must be spent on his nursing home cost as one of the conditions for receiving Medicaid. By applying most of his SSDI payment, he receives an actual monthly Medicaid benefit for room and board of \$2,385.

If Robert loses his Medicaid eligibility, he will be forced to pay privately for the services he needs at significantly higher rates because he will lose the benefit of the lower price negotiated between the state where he resides and his state's Medicaid service providers. Paying privately, his nursing home costs would increase from \$3,300 to \$4,500, his medications would double from \$1,250 to \$2,500, and his physical therapy would also double from \$1,000 to \$2,000. On an annual basis, Robert would be

paying \$108,000 for the same services that the state would pay \$66,600 for.

Faced with these circumstances, Robert is initially presented with two options. Under Option One, he can receive his settlement outright, lose his Medicaid eligibility, rapidly deplete his assets by paying privately, and reapply for Medicaid. Under Option Two, Robert can receive his settlement through a special needs trust, preserve his Medicaid eligibility, preserve his assets, and avoid the need to reapply for Medicaid in the future. The two tables and accompanying text below vividly illustrate these two options.

Option One

Upon receiving his \$450,000 settlement, Robert will become ineligible for his Medicaid benefits and must begin paying privately. His first year's annual nursing home cost of \$108,000 will translate into a \$9,000 monthly cost that will need to be met by Robert's \$950 SSDI payment and \$8,050 from the settlement proceeds. Assuming an annual return of eight percent, this payment schedule will result in the settlement being reduced to \$387,127.87 by the time Robert is ready to live independently one year later.

Spending \$125,000 on a modest house, \$40,000 on a specially equipped van, and \$15,000 on a specially equipped wheelchair will further reduce Robert's settlement to \$207,127.87. Although moving from the nursing home will decrease his monthly costs by \$4,500, he will realize only a \$2,000 overall reduction in his monthly expenses. His expenses will be \$7,000 rather than \$9,000 because he will need to continue paying \$2,500 monthly for his medications, \$2,000 for his physical therapy, and \$2,500 in additional monthly living expenses that

he will incur as a result of living independently.

To meet this total monthly expense of \$7,000, Robert will need to use all of his \$950 SSDI payment and \$6,050 from his settlement proceeds. As Table One illustrates, Robert's settlement proceeds will be totally dissipated in less than five years from receipt, and he will need to reapply for some type of public assistance. While his house, van, and wheelchair will not count against his eligibility determination, he will no longer have any supplemental fund with which he can take care of basic maintenance.

Option Two

Upon reaching a net settlement of \$450,000, Robert preserves his Medicaid benefits and avoids having to pay privately by using the proceeds to fund a SNT. Because he preserves Medicaid, his settlement will not be reduced during the first year that he remains in the nursing home in anticipation of living independently. While the majority of his \$950 SSDI payment will continue being paid to the nursing home as before, this will have no negative effect on preserving the settlement or his Medicaid.

Assuming the same annual return of eight percent on the settlement that is now in the SNT, Robert's settlement will increase to \$487,349.78 at the time he is ready to live independently one year later. This increase is in stark contrast to the reduction that results in a value of \$387,127.87 as in Option One above. Similarly, when Robert is ready to live independently and spends \$125,000 on a modest house, \$40,000 on a specially equipped van, and \$15,000 on a specially equipped wheelchair, this will only reduce the settlement to \$307,349.78 instead of the reduction in Option One to \$207,127.87.

Table 1. Settlement Received Outright

Year	Fund Value	Fund Earnings	Expenses	Fund Value Year End
Year 1*	\$450,000.00	\$33,727.87	\$276,600.00	\$207,127.87
Year 2	\$207,127.87	\$14,469.46	\$ 72,600.00	\$148,997.33
Year 3	\$148,997.33	\$ 9,644.65	\$ 72,600.00	\$ 86,041.99
Year 4	\$ 86,041.99	\$ 4,419.39	\$ 72,600.00	\$ 17,861.38
Year 5	\$ 17,861.38	\$ 4,419.39	\$ 72,600.00	-\$ 50,319.23
Totals		\$66,680.76	\$567,000.00	

* Purchased House, Van & Wheelchair

Table 2. Settlement Proceeds Deposited Into A Special Needs Trust

Year	Fund Value	Fund Earnings	Expenses	Fund Value Year End
Year1*	\$450,000.00	\$ 37,349.78	\$180,000.00	\$307,349.78
Year 2	\$307,349.78	\$ 24,812.49	\$ 18,600.00	\$313,562.27
Year 3	\$313,562.27	\$ 25,328.13	\$ 18,600.00	\$320,290.40
Year 4	\$320,290.40	\$ 25,886.56	\$ 18,600.00	\$327,576.96
Year 5	\$327,576.96	\$ 26,491.34	\$ 18,600.00	\$335,468.30
Totals		\$139,868.34	\$254,400.00	

* Purchased House, Van & Wheelchair

In addition, because Robert preserved his Medicaid eligibility, he can apply for one of the Home and Community Based Service programs (HCBS) in his state.⁶ Under the state plan in Robert's state, Medicaid will pay for his medications, physical therapy, and a very limited amount of home health care if he resides in the community. Because Medicaid will cover the costs of his medications and physical therapy, Robert's total monthly living expenses will only be \$2,500 rather than \$7,000 as in Option One.

As an additional benefit, Robert's HCBS program does not require him to apply his SSDI payment toward his share of Medicaid benefits. This means that applying the \$950 SSDI payment to his monthly living expenses of \$2,500 will only necessitate using \$1,550 from his SNT each month. Using \$1,550, as opposed to the \$6,050.00 scheduled under Option One, will allow the settlement proceeds to compound rather than being consumed by living expenses. As Table Two illustrates, Robert's settlement proceeds within his SNT will be valued at approximately \$335,000 on the same calendar date that all of the proceeds are consumed under the plan in Option One.

In addition to the utility demonstrated in the two tables, there is a corollary benefit that often escapes the attention of SNT beneficiaries and their families. As the above examples indicate, public assistance benefits are delivered at a reduced cost that has been negotiated between the service provider and the particular state where the recipient resides. As noted, this negotiation results in a cost that is significantly lower than the cost of paying privately for the same services.

In addition, these negotiated costs can work a secondary advantage in those cases where the SNT's payback provisions become effective and the trustee

must reimburse the state dollar for dollar. This secondary advantage is realized because the reimbursement is made at the reduced rate paid by the state and not at the private rate, which the individual would have had to pay. Furthermore, the reimbursement functions as an interest free loan from the state because no interest or surcharge is added to the reduced base cost of the lifetime assistance provided to the trust beneficiary.

Distribution Standards and Other Specialized Administrative Issues

Thus far, this article has been concerned primarily with issues relating to establishing a SNT. However, we have reached a point where it is important to realize that establishing a SNT is the first step of a two-step process.

The first step is to protect assets and create a supplemental fund. This first step is accomplished through proper drafting so that all statutory requirements are met and so that the assets will not be counted as an available resource. As complex as this first step can be, the second step is typically even more complicated and far-reaching because it involves administering the SNT in relation to the rules governing the trust beneficiary's public-assistance program. Also, while establishing the SNT covers a relatively short time from beginning to end, administering the SNT covers a much greater period because it will potentially span the beneficiary's lifetime. To administer the SNT successfully over this extended period, the trustee must always adhere to a proper set of distribution standards.⁷

As a general rule, the trustee must always ensure that distributions are completed in such a manner as

to prevent them from being counted as income under the rules that control the beneficiary's public assistance program (the "program rules").⁸ While it is ostensibly very easy to state this standard as a general rule, understanding the rule's implications necessitates understanding a somewhat subtle paradox that the trustee often faces when making distributions.

On one hand, following a standard that is dictated by the beneficiary's program rules can be very beneficial because it allows SNT documents to be highly flexible and adaptable. For example, if a SNT beneficiary becomes eligible for other public assistance programs in the future, the trustee can adapt the administration by simply continuing to follow the same broad standard of compliance with all the beneficiary's program rules. Because the trustee's primary distribution standard is to always comply with the beneficiary's program rules, the trustee has a duty to adapt to any new program.

On the other hand, however, this same flexibility can potentially work to the beneficiary's disadvantage because the trustee's duty to adapt often results in much administrative complexity. The primary source of this complexity can be traced to the government assistance programs on which the trust beneficiary relies. Understanding these assistance programs is crucial to properly administering a SNT.

Why Government Assistance Programs Are Complex

Government assistance programs are delivery systems authorized under the Social Security Act (the "Act"). Unfortunately, the Act is commonly recognized as presenting a bewildering degree of complexity.⁹ When we speak of government assistance programs that are authorized under the Act, we are primarily concerned with the Supplemental Security Income (SSI) program and all the various state Medicaid programs.

Since eligibility for SSI brings automatic eligibility for Medicaid, many of the rules that govern Medicaid are based on the rules that govern SSI. However, any similarity between SSI and Medicaid generally serves as an additional source of confusion rather than a source of clarity or understanding. For example, SSI is funded with federal money but administered with state participation, much like a joint venture. On the other hand, while Medicaid is

funded with federal grant money, it is administered by the states independently of the federal government. The distinction is that SSI is a federal program administered with state participation, while Medicaid programs are state programs funded in part by the federal government.

The distinction between the federal and state aspects of these programs is subtle but significant. Briefly, because all these programs involve federal and state government, both federal and state laws ultimately govern them. In the case of Medicaid, the addition of state law results in the introduction of state-by-state variation. In addition, each program is then subject to interpretation by federal code and state code. Each is finally given effect through various federal and state administrative rules.

The interaction of these various laws, codes, and agency regulations creates an inherent level of complexity that is difficult to understate. In addition, the states must cover certain groups and provide specific coverage as a condition to receiving the federal grant money that funds the state programs. Despite the conditions placed on the states, however, the federal government allows options and gives some latitude as to how programs are implemented in each of the states.

The latitude afforded by the federal government results in variance between Medicaid programs from state to state and introduces yet another level of complexity. For example, in Florida, where the authors reside, there are currently thirteen different adult SSI related Medicaid programs operating throughout the state. Each Medicaid program provides different benefits and presents different eligibility requirements. Like Florida, the other states all operate a variety of Medicaid programs that vary internally in addition to varying with other state programs. Ultimately, it is the confluence of all these factors discussed above that accounts for the complexity of government assistance programs and that introduces complexity into SNT administration and necessitates the employment of specialized administrative skills.

Additional Distribution Issues

In addition to the broad standard of complying with the specific requirements of the beneficiary's program rules, the trustee must also successfully contend with two interrelated concepts. The first concept relates to the statutory requirement discussed earlier that all SNTs must be established for the "sole benefit"

of the beneficiary.¹⁰ The second concept concerns distributions that result in the SNT beneficiary receiving fair market value in the distribution or exchange.

While the relationship between these two concepts can often present practical difficulties for the SNT trustee, a distribution that results in a fair market exchange will most often meet the sole benefit requirement. The practical difficulties that these concepts can present to the SNT trustee are simply noted here because they concern distribution issues. However, these difficulties will be examined more closely in the section of the article that addresses the ethical issues of SNT administration because they can present some very difficult issues that do not lend themselves to ready solutions.

As a final distribution issue, beneficiaries and their families frequently question whether any distributions may be made prior to satisfying the SNT's payback provisions at the beneficiary's death. The answer to this question was not completely settled until the fairly recent release of an Emergency Memo by the Social Security Administration (SSA). Dated May 14, 2001, SSA Emergency Memo, EM-01085, clarified POMS SI 01120.203 B.1 and SI 01120.203 B.2.g.¹¹ This Emergency Memo explains that distributions for state or federal taxes owing as a result of the beneficiary's death may be made prior to satisfying the SNT's payback provision. Permissible distributions also would include reasonable fees for administration of the trust estate and other services related to terminating the trust.

However, specifically excluded as permissible distributions are distributions to third-party debtors and the payment of funeral expenses. In light of the clarification on these points, funeral expenses and those debts owed to third parties that the beneficiary would like to be paid should all be paid prior to the beneficiary's death.

Some Potential Tax Consequences of Establishing a Special Needs Trust

Since the beneficiaries of SNTs need to meet financial eligibility requirements, which impose strict asset and income limitations, professionals who are new to SNTs will sometimes make the initial assumption that taxes are not an issue. This is not the case, however, and professionals must consider a number of tax issues in both the drafting and administration of a SNT.

This section of the article will examine the potential income tax, gift tax, and estate tax

consequences that should be part of the planning process and incorporated into the administration process.

Grantor Trust Status and Income Tax

Whether or not the Internal Revenue Service (IRS) considers a SNT to be a grantor trust can potentially have significant tax consequences for the trust beneficiary. If the IRS determines that the trust is a grantor trust, then all net income generated by the trust will be passed through to the beneficiary and taxed at whatever rate is applicable to the beneficiary's tax bracket for any given year. On the other hand, if the IRS determines that the SNT is a non-grantor trust, then all net income generated by the trust will be taxed at the much higher trust rate. Section 1 of the Internal Revenue Code (the Code), imposes a rate that begins at fifteen percent and quickly progresses to a maximum amount of 39.6 percent on all taxable income in excess of \$8,650.¹² To avoid this higher rate and receive the more beneficial grantor tax status, the trust document must contain one of the provisions found in Sections 671 through 679 of the Code.¹³

Assuming the SNT meets the test for a grantor trust, the trustee has several options to consider for filing tax returns with the IRS. Under one option, the trustee would file IRS Form 1041 on behalf of the SNT and would issue a Form K-1 to the beneficiary for all distributions and income items allocated to the beneficiary. Filing a 1041 requires the trustee to obtain an employer identification number (EIN) from the IRS by filing Form SS-4.

Alternatively, the trustee can opt for what is potentially a simpler method by using the beneficiary's social security number rather than a separate EIN. This second option allows for two additional approaches for tax reporting.¹⁴ Under the first approach, the trustee must furnish the beneficiary's name, social security number, and address of the trust to all account holders and payors of income in addition to obtaining a signed Form W-9 from the beneficiary. Under the second approach, the trustee must provide the trust's name, address, and tax identification number to all account holders and payors of income and issue a Form 1099 to the beneficiary that shows all income or gross receipts. In turn, the beneficiary files a standard Form 1040 and attaches a statement reporting all income, deductions, and credits for the trust.¹⁵

Regardless which approach the trustee uses, the beneficiary must be provided with a statement that shows all the trust information the beneficiary will need to report when completing his or her personal tax return, along with notice that all this information is required to be included on the return.¹⁶

Tax Issues at the Time of Funding a Special Needs Trust

At the time of funding, income tax liability is usually not an issue if the SNT is funded with assets currently owned or received by the beneficiary. For example, no income tax is due when a statutorily authorized party establishes a SNT on behalf of the beneficiary and then funds the trust with assets in which the beneficiary possesses an ownership interest. Capital gains tax will also be avoided if the beneficiary's capital assets are retitled in the name of the trustee rather than being liquidated as a condition of funding.

In cases where the SNT will be funded with proceeds from a personal injury action, there is the potential for mixed results. For example, all the settlement proceeds will be excluded from the beneficiary's gross income if all the compensation is paid for injuries or sickness. Section 104(a) of the Code describes five categories of compensation that are eligible for this exclusion.¹⁷ To the extent any of the proceeds are awarded as damages for anything other than these excluded categories, they will not be excluded from the beneficiary's gross income.¹⁸ Also, if a beneficiary accepts a lump sum settlement that is excluded from gross income, but the proceeds sit in an account accruing interest while the settlement details are finalized, all the accrued interest will be included in the beneficiary's gross income.

Accrued interest can also have potential implications when the SNT beneficiary accepts periodic payments as part of a structured settlement rather than receiving a lump sum. Because a portion of each payment will represent receipt of the settlement proceeds while another portion will represent interest earned on the proceeds, it is crucial that the periodic payments are structured properly under Section 130 of the Code. Assuming the structure complies with Section 130 as is typically the case, then the interest portion of the payment will be excluded from the beneficiary's gross income along with the portion that represents the underlying award.

The same favorable tax result will be obtained without regard to whether the periodic payments are

paid to the SNT or paid directly to the beneficiary. However, it is important that the SNT be named as payee of the periodic payments to avoid having the payments count toward the beneficiary's income under the beneficiary's applicable public assistance program rules.

Another issue to consider at the time of funding a SNT is whether or not the beneficiary has made a completed gift, which would trigger gift tax liability under Section 2501 of the Code for all of the funds in excess of the current annual exclusion of \$10,000. Generally, the beneficiary will have made a completed gift to the extent dominion and control of the property has been completely transferred.¹⁹ In cases where the SNT is being funded with negotiated settlement proceeds, gift tax consequences can likely be avoided by characterizing the proceeds as the receipt of consideration for the released claim.

However, under any circumstances when the funds can be characterized as belonging to the beneficiary, gift tax liability can be a potential problem at the time of funding the SNT. One technique for avoiding this potential liability is for the beneficiary to retain a power of disposition over the SNT assets, such as a testamentary limited power of appointment over the SNT's remainder interest.²⁰ Retaining such a power should avoid having the SNT's funding characterized as a completed gift.

An issue related to the above gift tax issue is the potential for estate tax liability. While retaining a limited power of appointment can avoid gift tax liability at the time of funding the trust, it will also guarantee that any funds remaining in the trust at the beneficiary's death will be included in the beneficiary's gross estate for estate tax purposes.²¹ This potential for estate tax liability may or may not be an actual problem at the time of the beneficiary's death. For example, even if the result is to make an ostensibly even trade of gift tax liability for estate tax liability, the deferral period during which no tax is due will result in all the trust assets being available for the beneficiary's special needs during the beneficiary's lifetime. Not only does maximizing the assets during the beneficiary's lifetime better effectuate the primary purpose of establishing a SNT, but it also creates the potential that the funds may be used to such an extent that no estate tax will be due at the beneficiary's death.²²

Should estate tax liability be a realistic concern that is unavoidable given a particular set of

circumstances, the most important consideration will be to plan for sufficient liquidity. Because estate taxes are due within nine months of the decedent's death, it is critical that assets are on hand to meet this liability so that substantial interest and penalties are avoided.

In the case of a structured settlement, one method for insuring liquidity is to provide a commutation clause in the annuity that funds the underlying obligation to make periodic payments to the beneficiary. Life insurance is another time-honored method to insure liquidity for estate taxes, but it can potentially be a problematic method in the case of a SNT because trust distributions must be for the sole benefit of the beneficiary.

Accounting Issues

As an opening comment on a trustee's duty to provide accountings, professionals should be familiar with their particular states' laws regarding the specific accounting requirements relative to those states. Despite the specific requirements of state law, the Uniform Tax Code (UTC)—formerly the Uniform Trust Act—is generally illustrative of a trustee's duty to account.²³

A significant number of the principles embodied in the UTC are reflected in many state statutes governing trust law even when not expressly adopted. Section 813 of the UTC expresses the trustee's duty to inform trust beneficiaries and provide reports. Again, while the specific details of this duty are the subject of state law, the UTC articulates the fundamental duty to keep beneficiaries reasonably informed as to all aspects of the trust's administration. For example, this duty would include providing notice that the trustee has accepted the office, providing the trustee's name, address, and telephone number, and providing advance notice of any change in the trustee's compensation rate. It would also include providing an accounting, at least annually, that shows all receipts, all disbursements, all liabilities, a current list of all the trust's assets, and if feasible, the current market value of all of the trust's assets.

Beyond the duties specifically imposed under state law, however, the SNT trustee has a specialized accounting duty that can be central to protecting the beneficiary's eligibility for public-assistance benefits. As discussed much earlier in this article regarding distribution standards, the trustee must always insure that distributions are completed in such a

manner as to prevent them from being counted as income under the rules that control the beneficiary's public assistance program, or program rules. Relative to accounting, these distribution standards translate into a duty to be able to account for each distribution such that the trustee can demonstrate it should not be counted as income.

As a prudent practice standard, this means that each distribution should be well documented as to its purpose and to whom the distribution was made so that it can withstand scrutiny from the agency responsible for administering the beneficiary's public assistance. This practice is especially important to follow when distributions are made to family members for reimbursement or for services currently being provided. Without proper documentation, such a distribution can be construed as a gift thereby violating the sole benefit rule.

Regarding the provision of these accountings to federal and state agencies, there is one school of thought that holds accountings should be filed with the appropriate agency so that its ability to challenge trust distributions within a given accounting period will have a cut-off date. Without regard to whether the trustee files accountings or not, however, the trustee should always maintain records and documentation supporting that all distributions have been made for the beneficiary's supplemental needs and for the beneficiary's sole benefit.

Investment Responsibilities

In discussing the trustee's investment responsibilities, it is impossible to escape an examination of the Prudent Person Rule and how it differs from the more modern Prudent Investor Rule. The Prudent Person Rule is a standard of care that developed over considerable time and was established by the leading case of *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830). Not specifically a standard of the trustee's investment duties, the Prudent Person Rule embodies a standard that is applied to all areas of fiduciary administration.

The standard is based on what other similarly situated trustees are doing and is very much the same as the reasonable person standard found in tort law.²⁴ Prior to the development of the Prudent Person Rule, so called "legal lists" developed out of the case of *King v. Talbot*, 40 N.Y. 76 (1869). The primary considerations driving the formulation of these legal lists were the preservation of capital at the avoidance of risk.

While these legal lists created a safe haven for fiduciaries, over time it could be demonstrated that legal lists worked to the detriment of beneficiaries. As any student of the financial markets can attest, the safe investment of one generation can be the minefield of another generation. The most famous example of this may be the Harriman Family Trust, which stipulated that only railroad stocks could be purchased by the trust. While this may have been a prudent trust investment in the 1890s, such an investment could hardly be considered prudent 100 years later during the 1990s.

While the Prudent Person Rule offered some relief to the difficulties presented by the legal lists, it came to be criticized for its own shortcomings. First, while the rule does not directly speak to this issue, it works in practice to make the trustee almost a guarantor of investment performance. Another criticism is that the rule also improperly favors residual beneficiaries at the expense of income beneficiaries because it focuses on the preservation of principal. In addition, the rule fails to view investments in the larger context of all the trust's investments because it looks at each investment and its performance individually. This last criticism is especially well founded because viewing investments individually is directly contrary to Modern Portfolio Theory.

In 1974, Congress enacted the Employee Retirement Income Security Act (ERISA), which established guidelines for pension fund operation and investment management. ERISA relied heavily on the investment concepts, which had been emerging over the previous two decades. These theories were collectively known as Modern Portfolio Theory. The introduction of Modern Portfolio Theory into the pension arena transformed the way retirement investing was viewed. Instead of protecting principal at all cost, total return and growth of assets became paramount. In contrast to the Prudent Person Rule, the Prudent Investor Rule incorporates these principles of Modern Portfolio Theory and requires trustees to redefine their role regarding trust management.

The more modern Prudent Investor Rule was adopted and promulgated as the Uniform Prudent Investor Act (the Act) by the National Conference of Commissioners on Uniform State Laws at its annual conference in 1994. The Act was subsequently approved by the American Bar Association on February 14, 1995. To date, the Act has been adopted in some form by 35 states and the District of Columbia.

As the Uniform Law Commissioners observe in the Act's Prefatory Note, the Act recognizes the changes that have occurred in investment practice, and it draws upon the revised investment standards promulgated by the American Law Institute in the Restatement (Third) of Trusts; Prudent Investor Rule (1992).²⁵ Accordingly, the Act identifies five broad objectives that it seeks to implement.²⁶ The first objective is to introduce a standard of prudence that looks at the total portfolio and considers individual investments within this larger context.²⁷ The second broad objective is to consider the trustee's central duty to consider the tradeoff between risk and return, while the third objective seeks to remove all categorical restrictions imposed by legal lists.²⁸ Also, the Act integrates a trustee's well-established duty to diversify investments into the definition of prudent investing.²⁹ Last, the Act reverses the much-criticized rule that did not allow the trustee to delegate investment and management functions.³⁰

With the implementation of these objectives, the Prudent Investor Act challenges trustees to reconsider their investment decisions. This is because investments that may have been viewed as "safe" in the past may no longer fulfill the trustee's fiduciary duty and protect the trustee from liability. While this may be disconcerting for some trustees, those trustees who take the time to understand the Prudent Investor Act will come to realize that it is a step forward for themselves and the beneficiaries to whom they owe a fiduciary duty. It is a step forward because it recognizes the realities of the market place and allows trustees to delegate investment duties to more qualified professionals. This is of particular benefit for the many trustees of SNTs who are family members of the beneficiary and who lack the professional sophistication to perform all the duties personally that are required of them as trustees.

Ethical Issues

Both the drafting and administration of a SNT presents an array of ethical concerns for the professional. In addition, many of these ethical issues also carry the potential for professional liability. For example, professionals should be fully competent in the analysis of current and future public assistance benefits before accepting SNT clients. In this regard, both drafting competency and administrative competency are crucial to the ethical duty of acting in a client's best interests and decreasing the potential for liability.

A related issue concerns the appropriateness of professional fees for services that are highly specialized and for which the professional may not be entirely prepared to provide. Given the multi-disciplinary setting in which many SNTs are created and administered, the professional also needs to stay alert to maintaining client confidentiality and to disclosing any actual or potential conflicts of interest.

While all these above examples raise viable concerns and should be given due consideration, they are the subject of more traditional ethical discussions that can be found to receive varying degrees of treatment in existing texts on professional ethics. By contrast, the authors of this current article have experienced an ethical dilemma on a number of occasions that is not typically treated in the literature that has emerged, and continues to emerge, concerning SNTs. This ethical dilemma concerns the practical relationship between the SNT trustee's narrow and specialized duty to protect eligibility for public assistance and the broad and traditional duty of always acting in the beneficiary's best interests.

In practical terms, preserving the beneficiary's eligibility means using the trust assets for supplemental needs that will improve the beneficiary's quality of life and provide for increased independence and autonomy. Under this standard, the trust beneficiary and his or her family members should guide the trustee to the greatest extent possible because they stand in a far better position to make decisions about quality of life issues and autonomy.

Many relationships between the trustee and beneficiary begin with a general understanding that the trust will operate with the greatest amount of latitude possible and that the trustee's discretion will be guided primarily by the duty to protect eligibility and increase the beneficiary's autonomy. When the trustee follows this operational pattern, it can sometimes lead to a quicker depletion of the trust assets than might otherwise be the case.

However, absent a situation where family members are attempting to unduly influence distributions, the beneficiary can realize a very beneficial effect when he or she has some input into determining their supplemental needs. It is difficult to put a value on what this autonomy can mean to someone who daily experiences diminished autonomy as a result of their disability. With smaller trusts in particular, the long-term benefit of extending the life of the trust assets often becomes secondary to the value that many

beneficiaries place on directing the use of their trust and receiving a more immediate short-term benefit.

The ethical dilemma that this arrangement presents to the trustee lies in trying to determine whether preserving or depleting the trust assets will be in the beneficiary's best interests. SNTs present very diverse human issues and each case is very fact specific. Although it is rarely an easy determination to make, the factors to consider typically include the value of the trust assets, the beneficiary's projected life expectancy, and the beneficiary's long-term needs.

The following example illustrates what can occur when the beneficiary's intent as to how the trust assets should be used collides with the trustee's determination as to what is in the beneficiary's best interests. (As a preface to this example, the authors are compelled to state that their philosophical inclination is to administer SNTs so that every effort is made to effectuate the beneficiary's intent while preserving eligibility.)

Like the trust beneficiary in our financial example above, the beneficiary in this current example is also paraplegic as a result of an accident. Unlike our previous example, however, Billy is 24 years old and is very motivated to create a new life for himself. In fact, Billy intends to buy a house, start a business with his father, and marry his current girlfriend in the near future. No matter how Billy's plans may turn out, the trustee is initially impressed that Billy seems to have latent talent and a tremendous drive to build a future.

During his early meetings with the trustee, Billy explains that he knows exactly how he wants to see his SNT administered. He and his father, William, know a mortgage broker who can absolutely secure a mortgage for the house Billy wants to buy and the trust will make a \$40,000 down payment. Billy wants to take out a mortgage so that the trust assets will remain available for investment and outperform the interest rate charged on the note.

He is also confident that his business venture will be successful because his father has extensive experience in the industry and is recognized locally for his expertise. Billy explains that his father had a successful business for years and lost it as a result of Billy's accident and the ensuing time he took to provide for Billy's care. They ostensibly have a business plan prepared, and Billy assures the trustee that a commercial lender is prepared to lend them \$225,000. An additional \$100,000 will be provided

by the trust, which will be used as a down payment for a commercial property and for operating capital.

If Billy's plans go according to schedule, his SNT will contain in excess of \$250,000 after all these business expenses, after his van is paid off, and after a number of other immediate needs are met. Billy's plan is to preserve these remaining assets and let them grow for the future. Managing these assets for growth is an important component of Billy's plan because he will clearly have significant ongoing needs that the SNT will need to supplement in the future.

While the plans that Billy has for his trust are somewhat unusual, the trust instrument has been carefully drafted to allow such a use of the trust assets on the condition that eligibility is protected. The trustee explains what steps will need to be taken to effectuate these plans while protecting Billy's benefits.

While Billy is willing to follow whatever formalities the trustee considers necessary, his plans begin to unravel shortly after his SNT is funded. The first difficulty arises when the mortgage broker cannot find a lender that will offer a reasonable rate on the mortgage. Despite having had several conversations with the trustee's money manager, who expressed his understanding that mortgages were not readily available under these circumstances, the broker continued to assure everyone that he could deliver a mortgage. Because it is impossible for the trust assets to outperform the best mortgage rate available to the broker, the trustee decides it is financially prudent to pay cash for the house.

Without regard to Billy's plans, paying cash also works to Billy's advantage because making mortgage payments would have introduced a high degree of complexity into the administration of his trust given his particular public assistance program. In any event, paying cash reduces the trust assets by \$170,000, which is a reduction of \$130,000 more than Billy's plan anticipated. While Billy now has clear title to his home, this turn of events leaves \$120,000 in his trust rather than \$250,000.

The next difficulty arises when Billy's commercial lender declines to make the loan. Billy assures the trustee that the loan was declined because the lender has invested in its quota of businesses like Billy's and that there are other lenders who are willing to make the loan. However, Billy and his father have still failed to secure a loan several months later. The trustee also discovers from a reliable source that

Billy's father did operate his own business for a number of years, but his bankruptcy had no direct relationship with Billy's accident. The trustee also learns directly that Billy's father is continuing to experience financial difficulties.

Shortly after the trustee discovers this information, Billy comes forward with a modified plan. The plan is for the trust to still invest \$100,000, but now there will be no other capital provided from any other source, including Billy's father. If the trustee follows Billy's wishes, the assets in his SNT will be reduced in value to \$20,000, which will leave virtually nothing for his future needs. In addition, on the basis of offhand comments made by Billy, the trustee has reasonable cause to believe that he will mortgage his house for additional capital once the initial \$100,000 investment is made.

However, even with this additional capital, the business will be grossly under-capitalized on the basis of the numbers that Billy and his father have provided. In addition, Billy and his father express increasingly unrealistic expectations and objectives as these events unfold. All these events strongly suggest that Billy will end up with just \$20,000 in trust and a mortgage on his house because the numbers clearly indicate the business will fail.

Obviously, the ethical dilemma presented to the trustee does not concern maintaining Billy's eligibility for public assistance. While the trustee could make all of these distributions in such a manner as to preserve Billy's eligibility, all factors indicate that the distribution will not be in his best interests. If the business fails, it will present very serious problems for Billy because he will never be able to keep his house under such circumstances, and he will become totally dependent on his public assistance. However, the trustee's decision is not as clear as it may first appear. While the trustee can defend a refusal to invest in the business under these facts, Billy really wants the distribution to be authorized. Without regard to the business's success, Billy places a high degree of value on just being able to try and make it a success. Also, for whatever protection it might provide after the business fails, the trust document specifically holds the trustee harmless from any investment in a family business that ultimately proves to be a failure.

The combination of all these factors creates a very difficult ethical position for the trustee in this example. Because of the unique facts and divergent

duties presented by Billy's SNT, there is no clear authority to which the trustee can turn. As is often the case, the SNT trustee in this example must make a decision that will likely always remain open as to whether or not it ultimately worked to the beneficiary's best interests.

Conclusion

While SNTs are conceptually very simple and provide a narrow exception to the rules that normally apply to trusts, this article has demonstrated that the actual creation and administration of a SNT can be very complex because the rules that regulate gov-

ernment assistance programs are inherently complex.

As SNTs continue to be used with ever-increasing frequency, the need for professionals to understand the technical and practical issues that arise in connection with SNTs cannot be overstated. Although state statutes and local requirements are critical in this regard, this article should alert astute professionals to most of the major issues they can expect to confront. In turn, this can hopefully have a beneficial effect on the counseling that beneficiaries and their families receive, and better equip them to make an informed decision as to the suitability of using a special needs trust.

Endnotes

1. The extent to which special needs trusts are viable planning vehicles is evidenced by the frequency with which they are routinely considered and used. In most local jurisdictions, it is fair to characterize a petition for authority to establish a special needs trust as almost commonplace. These petitions are met with almost routine approval by the courts when doing so is in the best interest of the potential special needs trust beneficiary. In addition, The ARC of the United States (Association of Retarded Citizens) recently released a report listing 35-pooled trusts, in 22 states, that have been established by various non-profit associations across the country. A pooled trust is a type of special needs trust.
2. The statutory requirements for establishing a special needs trust can be found at 42 U.S.C. § 1396p(d)(4).
3. The Omnibus Reconciliation Act of 1993 (OBRA 93) inaugurated what is often referred to as the most significant changes to Medicaid law since the program's inception in 1965. Among other changes, OBRA 93 strengthened transfer penalties, redefined the definition of assets, eliminated most trusts as planning options, and created the statutory provisions that allow for the creation of special needs trusts.
4. The authors maintain that Third Party Special Needs Trusts and all trusts created pursuant to OBRA 93 are rightly called special needs trusts because they all maintain eligibility for public assistance while creating a fund for supplemental needs. However, because (d)(4)(A) trusts in particular have come to be referred to as "special needs trusts" in common usage, the authors have found the term "disability trust" to be a useful way of distinguishing (d)(4)(A) trusts from (d)(4)(C) trusts when comparing their requirements and applicability to any given situation under OBRA 93.
5. See 42 U.S.C. § 1382c(a)(3); see also HCFA Transmittal No. 64, ST. MEDICAID MANUAL, pt. 3 § 3259.7(A) (1994).
6. Section 1915(c) of the Social Security Act authorizes certain statutory Medicaid requirements to be waived by the Secretary of Health and Human Services, which enables an assortment of services to be offered as an alternative to institutionalization. By forestalling institutionalization, Home and Community Based programs allow those participants to receive benefits who would not otherwise qualify. The necessity of obtaining this waiver has resulted in such programs being commonly referred to as Medicaid Waiver Programs; see generally HCFA Transmittal No. 64, ST. MEDICAID MANUAL, pt. 4 § 4440(A) (1994).
7. As a practical matter, the term "distribution" is used throughout this article as it is commonly understood and used by most SNT beneficiaries. In the authors' experience, most SNT beneficiaries use the term to describe any release of assets that come out of their SNT. While this article uses the term according to this common usage, it should be distinguished from its correct use by noting that it differs from traditional trust accounting terminology. Under traditional terminology, trust assets paid to a third party on behalf of a trust beneficiary are properly characterized as disbursements, while trust assets paid directly to a trust beneficiary are properly characterized as distributions. Absent

some extraordinary reason to the contrary, the trustee of a SNT would not make distributions directly to a SNT beneficiary.

8. While ensuring that distributions are not counted as income is clearly a standard for the SNT trustee, there are times and situations where exceptions are sometimes appropriate. Such situations would involve circumstances where the temporary loss or reduction of public assistance benefits is outweighed by the benefit of receiving what would otherwise be an improper distribution. Before employing such a strategy, however, the trustee should have a very good understanding of the beneficiary's program rules and the subsequent result of making such a distribution. The beneficiary, or designated representative, should also possess a good understanding of the cost-benefit analysis that goes into making the distribution and agree or request that it be completed.
9. *Friedman v. Berger*, 547 F.2d 724, 727 (2nd Cir. 1976) (courts have referred to the Act as intricate and Byzantine in its construction, and Judge Friendly is often quoted in his observation that the Act is, "almost unintelligible to the uninitiated.").
10. See HCFA Transmittal No. 64, ST. MEDICAID MANUAL, pt. 3 § 3258.10(B)(1); see also Social Security POMS SI 01120.201 F.1. Under the sole benefit rule, a trust will be considered to be established for the sole benefit of an individual if it benefits no one but that individual, whether at the time the trust is established or at any time during the individual's life. Despite this strict definition, provision is made for trustee fees and other fees related to the individual with regard to the trust.
11. While not having the force of law, Policy Operation Manuals, or POMS, is the internal set of agency regulations used by Social Security caseworkers in administering the various Social Security programs.
12. See I.R.C. § 1(e)(2) and inflation adjusted tax tables at Rev. Proc. 99-42, 1999-46 I.R.B. 568.
13. See generally, I.R.C. § 671-678. In determining whether a trust is a grantor trust, the key test can most generally be said to come down to the issue of control. In determining whether the grantor has maintained the requisite amount of control, it will become relevant as to whether the grantor has retained certain reversionary interests, the power to control beneficial enjoyment of the trust, the power to revoke the trust, certain administrative powers, or whether income is payable for grantor's benefit. NOTE: When drafting a special needs trust, it is important to insure that any retained power does not result in the trust corpus being deemed as an available resource, therefore defeating the purpose for which the document is being drafted.
14. Treas. Reg. § 1.671-4(b).
15. Because the Social Security Administration and most state agencies who administer state Medicaid programs have systems in place for cross checking the income of public assistance recipients through IRS records, using Forms 1099 and 1040 as an alternative tax reporting method may result in these agencies determining that a SNT beneficiary has received income in excess of their public assistance program's income limits. While income for tax purposes is a concept distinct from income for program limit purposes, it is an issue of which the practitioner should be aware and underscores the importance of properly documenting all trust distributions. The importance of properly documenting distributions is discussed in the accounting portion of the main text.
16. As an additional note on income tax, and without regard to the reporting method used by the trustee, a Form MISC-1099 should also be filed for any private caregivers who are not considered employees and who receive \$600.00 or more from the trust in the current tax year.
17. See I.R.C. § 104(a)(2).
18. A somewhat abbreviated list of the categories that Section 104 excludes from gross income include: 1) workers' compensation payments for personal injuries or sickness; 2) compensatory damages that are paid for personal physical injuries or physical sickness, without regard to whether they are paid in a lump sum or periodically (punitive damages do not receive the exclusion); 3) any amounts received through accident or health insurance, or similar arrangement, if received for personal injuries or sickness; 4) pensions, annuities, or similar payments as a result of personal injuries or sickness resulting from active service in the armed forces; and, 5) disability income that is attributed to injuries received as a direct result of a terrorist attack if the taxpayer was a U.S. employee engaged in the performance of official duties outside the United States at the time of the injury.
19. Treas. Reg. § 25.2511-2(b).

20. Treas. Reg. § 25.2511-2(c).
21. I.R.C. § 2033 requires the value of all property in which the decedent possesses any ownership interest to be included in the decedent's gross estate to the extent of the value of that interest.
22. *See* I.R.C. § 2010, amended by, Pub. L. No.107-16. Applicable to the estates of decedent's dying after December 31, 2001, the unified credit against estate tax set out in Section 2010 has been amended to provide credit for amounts up to one million dollars in 2002 and will increase incrementally until it reaches a maximum of three and a half million dollars in 2009. This current amendment also contains a sunset provision effective December 31, 2010.
23. The Uniform Trust Code (2000) is promulgated by The National Conference of Commissioners on Uniform State Laws.
24. John H. Langein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 644 (1996).
25. Copies of the Act may be obtained by contacting the National Conference of Commissioners on Uniform State Laws, 676 North St. Clair Street, Suite 1700, Chicago, Illinois, 60611.
26. *See generally* The Uniform Prudent Investor Act.
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.*