

SPECIAL NEEDS TRUSTS, Oregon State Bar CLE, July 18, 2003

Prepared by: Donna R. Meyer, Attorney at Law, FITZWATER & MEYER, LLP

TESTAMENTARY TRUSTS FOR PEOPLE WITH DISABILITIES

I. TYPES OF TRUSTS FOR INDIVIDUALS WITH DISABILITIES

Parents, grandparents, and other third parties often want to create a Trust for the benefit of a person with a disability. Just like in other estate planning scenarios, there are different types of Trusts that can be used, depending on the circumstances.

In some situations, the disabled person is not likely to ever receive needs-based public benefits, and the purpose of the Trust may be primarily to provide for ongoing management of funds for the disabled person's benefit. In these cases, a Discretionary Support Trust with terms tailored to the circumstances may be appropriate (see discussion below in section III.B).

In many other cases, the disabled individual is now receiving needs-based public benefits or is likely to receive them in the future, and in those cases, a Special Needs Trust may be appropriate (see discussion below beginning in section III.C)

Our most challenging situations are those in which we are not sure whether the beneficiary will or will not receive ongoing needs-based public benefits. For example, someone who has suffered a brain injury may be disabled now but over time may substantially recover to the point that public benefits won't be necessary. As another example, the beneficiary may have been diagnosed with a mental illness, and it is unclear at the time the client sees the lawyer whether the treatment will ameliorate many of the symptoms. An additional uncertainty is that we cannot be sure what public benefits might be available in the future. In these cases, we want flexibility. Some ideas about how to work with these situations are discussed in section III.C.4 and section IV.

II. DISCRETIONARY SUPPORT TRUSTS

A Discretionary Support Trust gives the trustee absolute and uncontrolled discretion to make (or refuse to make) payments for the benefit of the disabled individual. Distributions for basic needs such as food, clothing, shelter, and medical are allowed. This works well when the purpose of the Trust is to provide management for the funds and when the beneficiary does not receive public benefits and is not expected to receive public benefits in the future. The terms of the Trust can be tailored to the individual situation. In addition to the general support provisions, this is an opportunity to incorporate provisions that will insure the best possible "quality of life" for the beneficiary.

Does a Discretionary Support Trust that includes a spendthrift clause ever work to protect eligibility for public benefits? Arguably, the principal and income is unavailable because the beneficiary is unable to compel distributions for his or her basic needs. Courts that have addressed this issue look to the grantor's intent, which is evidenced in the language of the Trust itself. Trust assets to which a beneficiary has no right of access (or has a limited right of access) are unavailable except to the extent of the limited actual interest.

This approach is accepted by some government agencies and in some parts of the country. The Seattle Region of the Social Security Administration, of which Oregon is a part, currently does not deny benefits to recipients of SSI who are beneficiaries of wholly Discretionary Support Trusts which include a spendthrift clause. If the beneficiary cannot compel distribution under any circumstances, then the Trust is not treated as a resource. Of course, an actual distribution for food, clothing, or shelter will in most cases cause a reduction in benefits.

However, as noted above, government agencies are prone to changing policies, often without warning. There is no binding precedent in Oregon on which to rely. Reported cases throughout the country are mixed on Discretionary Support Trusts, and there are many cases that hold that even a trustee's absolute and uncontrolled discretion is tempered by the intent of the grantor.

Clifton B. Kruse, Jr., a noted elder law scholar and writer on this issue, has published a detailed study of these cases in his book, Third Party and Self-Created Trusts, Planning for the Elderly and Disabled Client.¹ He notes that The Restatement of Trusts (Second) provides that even a trustee with absolute and uncontrolled discretion cannot act arbitrarily or capriciously.² After reviewing the cases regarding Discretionary Support Trusts nationwide, he offers this conclusion:

It is clear that when lawyers consider Medicaid eligibility, unless the settlor intends the trust to be used for the beneficiary's support, language that specifically authorizes the trustee to use the entrusted funds for support purposes is inappropriately written. Beneficiaries of such trusts who are eligible for public medical benefits may or may not be able to continue receiving public support for basic necessities through dispensing agencies while at the same time receiving discretionary payments from privately endowed trusts for other purposes. The discretionary trust corpus may be deemed available for basic living needs. The case law is not consistent. The discretionary support trust is, therefore, an unreliable method by which settlors can continue to provide for their beneficiaries'

¹ Clifton B. Kruse, Jr., Third Party and Self-Created Trusts, Planning for the Elderly and Disabled Client, Third Edition, ABA, Section of Real Property, Probate and Trust Law, 2002.

² Restatement of Trusts (Second) section 187(j). See discussion in Clifton B. Kruse, Jr., Third Party and Self-Created Trusts, Planning for the Elderly and Disabled Client, supra, note 1 at page 58.

additional needs beyond basic necessities. The funds are at risk held in such trusts. The language encourages eager state agencies and their employees to attempt its indirect seizure. "Use it. Reapply (for public funds) when it's gone" may be their message."³

In short, Discretionary Support Trusts have their place. However, when drafting a Trust to protect eligibility for public benefits, the safest course is to use a more restrictive distribution standard.

III. Special Needs Trusts

A. Four Important Initial Questions

A reminder: before advising a client regarding a Special Needs Trust, a practitioner should ask four important initial questions.

First, is the beneficiary now receiving needs-based public benefits or is he or she likely to receive them in the future? If not, then a Special Needs Trust may not be necessary.

Second, if the beneficiary is receiving needs-based benefits, what are those benefits, precisely? Typically the beneficiary will be receiving more than one type of government assistance. The answer to this question may affect which distribution standard you recommend your client use in the Trust.

Third, who is the source of the funds? A Special Needs Trust created and funded by a third party for a recipient of public benefits is treated in some respects differently than a Special Needs Trust funded with the assets or income of a recipient of public assistance. If the Trust will be funded with the assets or income of a recipient of public benefits, then see the discussion in section VII.

Fourth, what are the beneficiary's particular circumstances? Will the beneficiary be able to pay for basic needs if distributions are limited to special needs? Again, we ask this question to help us decide which distribution standard to recommend to our client and whether to consider "contingent" trust planning.

B. Special Needs Trust Defined

Eligibility for needs-based public assistance programs is determined after a review of the assets and income of the person applying for help. If assets and income are *available* to

³ See Clifton B. Kruse, Jr., Third Party and Self-Created Trusts, Planning for the Elderly and Disabled Client, supra note 1, at page 69.

the person for food, clothing, and shelter, then generally the person is expected to use the available funds for those basic needs, thus reducing his or her need for government benefits.

Special Needs Trusts were developed by lawyers who realized that if a Trust, by its terms, makes the trust estate *unavailable* for food, clothing, and shelter, then the existence of the Trust should not affect an individual's eligibility for needs based public benefits.

Traditionally, a Special Needs Trust was created by a third party for a named beneficiary and funded with a third party's funds, either in a Will or an Irrevocable Living Trust. The availability of trust income and principal to a recipient of public benefits in a third party funded Trust will be determined based on the trust distribution standard.

If by the terms of the Trust the beneficiary is given the authority to control trust principal, either on his or her own or by directing the trustee, then the trust assets may be considered an available resource.⁴ Generally speaking, a Trust with a special needs trust distribution standard which is created and funded by a third party will not be considered as an available resource. Courts that have addressed this issue look to the grantor's intent, which is evidenced in the language of the trust itself.⁵

Some of the possible distribution standards are described below.⁶

C. Strict Special Needs Distribution Standard

A "special needs only" or "strict special needs" standard restricts distributions to special (or supplemental) needs, expressly prohibiting distributions for the basic needs of food, clothing, and shelter. Typically, distributions for medical expenses are limited by the terms of the Trust to those not otherwise covered by Medicaid.

The term *special needs* suggests needs particular to the person and his or her disability, such as medical equipment or rehabilitative treatment, and usually Special Needs Trusts do specify that distributions are allowed for such needs. However, a Trust limiting distributions to special needs can allow distributions for *anything* that is not food, clothing, and shelter, and medical needs that is covered by the public benefits program. This encompasses many things that are not related to a disability or medical treatment, and may not even be properly classified as a need. For example, a special need can include

⁴ POMS 01120.200-D-1-b.

⁵ See extensive review of cases in Clifton B. Kruse, Jr., Third Party and Self-Created Trusts, Planning for the Elderly and Disabled Client, supra note 1, beginning at page 70.

⁶ An excellent article summarizing possible distribution standards written by Cynthia L. Barrett can be found at "Distribution Standard for the Special and Supplemental Needs Trust," NAELA Quarterly, Summer 2001.

distributions for the cable television bill, Internet services, or vacation expenses.

Further examples of special or supplemental needs are as follows: medical insurance premiums, telephone services and equipment, transportation (including automobile, auto maintenance and repair, gasoline, auto insurance, and/or bus pass), recreation, education, pet care, subscriptions, and computer equipment and services.⁷ The list of potential distributions for supplemental needs is unlimited.

Perhaps of more use is to know what is **not** considered supplemental: rent, mortgage, property taxes, heating, gas and electric power, garbage, sewer, water, homeowner's insurance (if required by mortgage holder), clothing, and food.

A Trust limiting distributions to special needs is the safest course of action to preserve public benefits now and in the future. (See discussion regarding the possible dangers of a more liberal standard, such as giving the trustee the discretion to make distributions for basic needs above in section III.B.) The strict trustee of a Special Needs Trust has clear prohibitions. The government agency worker reviewing the Trust is more likely to readily recognize that the Trust is not disqualifying.

D. "Hybrid" or "Spigot" Approach

A more flexible approach to use in appropriate circumstances is to clearly state that the purpose of the Trust is to preserve the beneficiary's ongoing eligibility for public benefits and to provide for the beneficiary's special needs, but not to expressly prohibit all distributions for food, clothing, and shelter. The Trust provisions might also expressly allow distributions for some basic needs.

Courts typically interpret Trusts in light of their express purpose. With the hybrid approach, the stated purpose is to preserve the beneficiary's ongoing eligibility for public benefits, but flexibility is incorporated. This approach is clearly successful now for SSI beneficiaries in the Seattle Region, in which even Discretionary Support Trusts are accepted. A hybrid type standard is commonly used in Washington State. In Oregon, Seniors and People with Disabilities, the State agency that administers the Medicaid program, also accepts the "hybrid" distribution standard in third party funded trusts.

Caution: The practitioner should exercise extreme caution when advising the client about the options. When drafting any Special Needs Trust with a distribution standard that is not strictly limited to special needs, the effect of actual distributions should be considered. If the beneficiary actually receives a distribution from the Trust for basic needs, in most cases the benefits will be reduced. This can actually

⁷ For more information about the operation of special needs trusts, see Wesley D. Fitzwater and Richard Pagnano "Special Needs Trusts," Oregon State Bar CLE publication, Administering Trusts in Oregon, 1995, updated 2000.

cause termination of benefits in some circumstances. For example, if an individual is receiving Social Security Disability Income and only a small amount of SSI, then even a small distribution for basic needs may disqualify the beneficiary from both SSI and Medicaid. (See discussion regarding In-Kind Support and Maintenance in section III.D).

E. Purchase of Exempt Resources

The home where the individual (or spouse or minor child) resides or intends to return is exempt for purposes of eligibility for SSI and Medicaid.⁸ A provision allowing transfer of the exempt asset to the individual outright, free of trust, can be included with a Trust funded with third party assets. A common provision in Special Needs Trusts allows distributions for purchase of exempt resources, such as a home or car. (See section III.D.2 regarding the special issues involving a home.)

F. Trust Amendment

In the uncertain world of public benefits planning, it is generally advisable to include a provision allowing the trustee to amend the Trust if necessary to accomplish the stated trust purpose, which is to preserve public benefits. Although the trustee amendment power itself could, in theory, be scrutinized by the administrative agency, at this time it is, in this author's opinion, an acceptable risk.

G. Remainder Beneficiaries

The grantor is not required to name the state agency to receive the remaining trust property in a Trust created and funded by a third party.⁹

H. Estate Recovery

Under Oregon's current estate recovery rules, the remaining trust assets in a third party funded Trust are not subject to recovery at the recipient's death, because they were never owned by the beneficiary.¹⁰

IV. Paying for Shelter Costs--In-Kind Support and Maintenance

⁸ 20 CFR Section 416.1212.

⁹ See later discussion of the "Medicaid Payback Trust" for purposes of eligibility for Medicaid for long-term care and SSI, in which the State agency providing Medicaid must receive the remaining trust property to the extent assistance has been provided. However, this only applies to a Trust funded with the assets of the recipient.

¹⁰ OAR 461-135-832(14).

A. Generally

The home presents special issues. At the initial appointment the client often expresses a desire to assist the beneficiary with shelter costs, or to give the client's home outright to the beneficiary or to the trustee of the Special Needs Trust at death. The lawyer should understand the basic rules pertaining to the home and payment of shelter costs so that the client makes a choice for a Special Needs Trust knowing what is actually likely to happen.

As noted above, a home in which the trust beneficiary lives is exempt, so the beneficiary may own it outright. The Trust may also own the home. Treatment of a house owned by a Trust was a source of considerable confusion in the past. However, the Social Security Administration helped clarify the rule regarding home ownership by a Trust in the POMS issued in August, 1999. Under the POMS, a home-owning trust is not an outside source providing shelter to the beneficiary because the beneficiary "would be considered to be living in his/her own home based on having an 'equitable ownership under a trust.'"¹¹

There are several reasons why, if the Trust is a third party funded Trust (as opposed to a "Payback Trust" as recognized by federal and State law), it may be preferable to keep the home inside of the Trust. First, it may avoid estate recovery against the beneficiary's personal estate, depending on the beneficiary's age and the type of benefits received. Second, it allows the grantor to determine the ultimate distribution upon the death of the special needs beneficiary. Also, the home is often included in the Trust because the beneficiary lacks the capacity or judgment to manage such a significant asset. Last, the beneficiary may eventually sell the house, and net proceeds of the sale could make him or her ineligible for benefits. The beneficiary cannot simply transfer the house or the net proceeds back to the third party funded Trust without consequences, because the asset is now owned by him or her personally. To become eligible again it may be necessary to create a Payback Trust, which is available only if the beneficiary is under the age of 65. (See section VII.)

B. Paying for Shelter--In-Kind Support and Maintenance

The more difficult problem is whether the beneficiary can afford to pay for the shelter costs, which include mortgage (and rent), water, gas, electric, garbage, taxes, and homeowner's insurance (if required by the lender). The typical beneficiary of SSI often does not have sufficient non-trust income to cover these expenses. If the Trust pays for the shelter costs, it triggers the in-kind support and maintenance rules (ISM). It is important to have a sufficient understanding of the ISM rules to adequately explain to clients the impact of distributions when the "hybrid" or "spigot" distribution standard is chosen.

ISM is food, clothing, or shelter or anything that may be used to acquire these necessities

¹¹ SI 01120.200F(1)

that is provided by a third party, such as a Trust, at a reduced rate or no cost to the recipient.¹² Thus, an individual receives ISM when he or she receives food, clothing, or shelter directly without paying for it or receives these items because someone else pays for it.¹³ If the Special Needs Trust pays for shelter costs, there will usually be a reduction in the beneficiary's public assistance.

In-kind income is normally valued at the current market rate. There are two rules that govern how ISM will affect the SSI benefit: the one-third reduction rule (VTR) and the presumed maximum value rule (PMV). The composition of the household will determine whether the VTR rule or the PMV rule will apply. *However, to the extent that the Trust pays for the mortgage, property taxes, homeowner's insurance, and utilities from the trust assets, the PMV rule will apply and the VTR rule will not.*¹⁴ Note that if the Trust pays for improvements to the home, the individual does not receive income. Disbursements for improvements increase the value of the resource and thus do not provide ISM.¹⁵

If the Trust pays for shelter costs, the value will be deducted dollar for dollar from the beneficiary's SSI, but to a maximum of one-third of the federal benefit rate plus \$20. This year (2003) the federal benefit rate is \$552. One-third of the benefit rate is \$184. \$184 plus \$20 equals \$204. \$204 is the maximum amount that will be deducted in a month for shelter costs paid by the Trust.

Example of Distributions for Shelter that Help Beneficiary: Sally receives SSI in the amount of \$552 per month and SSI-linked Medicaid Assistance. Sally is the beneficiary of a Special Needs Trust with a substantial corpus that by its terms allows distributions for shelter that will reduce her public benefits. She lives in a house owned by the Trust (or owned by her outright). The taxes, utilities, and maintenance costs paid by the Trust are \$600 per month. There is no mortgage. Sally's SSI will be reduced by \$204, leaving her with \$348 per month to pay for food and clothing. The Trust can pay for her other needs and comforts, such as telephone, transportation, and the like.

Example of Distributions for Shelter that Hurt Beneficiary: Sally receives Social Security Disability Income in the amount of \$400 per month and Medicare. She also receives SSI in the amount of \$172 per month and SSI-linked Medicaid Assistance. Sally uses very expensive prescription drugs each month that are essential to her survival.

¹² 42 USC Section 1382a(a)(2)(A); 20 CFR Section 416.1102.

¹³ 20 CFR Section 416.1130(b).

¹⁴ SI 01120.200F(3)(b) and (c).

¹⁵ SI 1120.200F.3.c

As in the previous example, Sally is the beneficiary of a Special Needs Trust with a substantial corpus that by its terms allows distributions for shelter that will reduce her public benefits. She lives in a house owned by the Trust (or owned by her outright). The taxes, utilities, and maintenance costs paid by the Trust are \$600 per month.

Sally's SSI is only \$172, so it will be eliminated, leaving her with Social Security Disability Income only. Therefore, she will also lose her SS-linked eligibility for Medicaid. Depending on the State programs available at the time, Sally may lose coverage for her prescription drugs.

V. Coordinating Beneficiary Designations with the Plan

As with all estate planning, it is important to coordinate beneficiary designations with the plan. This includes life insurance, retirement plans, transfer on death designations and the like.

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