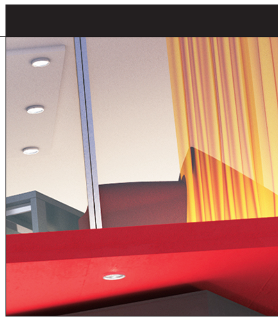

Supplemental Needs Trusts Have Special Drafting Needs

A supplemental needs trust can provide financial protection for a beneficiary without the repayment requirement of special needs trusts.

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Estate planning has always been a greater challenge for families with special needs beneficiaries, including those with developmental disabilities. As with any beneficiary, the objective is to design a structure that will optimize the beneficiary's ability to use and enjoy the gift or inheritance.

Gifts and inheritances have traditionally been structured to protect at-risk beneficiaries from themselves by considering factors such as age, maturity, and financial acuity. For example, a spendthrift trust may be created to protect gifts and inheritances from third parties with claims against a beneficiary's assets. A spendthrift trust prevents a beneficiary from transferring his or her interest in future payments. Thus, creditors are unable to access the beneficiary's interest for the payment of his or her debts.

Public benefit programs

Planning for a beneficiary with special needs triggers another important consideration when the beneficiary is, or may become, dependent on public benefits, including Supplemental Security Income (SSI) and Medicaid. The SSI program pays monthly benefits to individuals who have established eligibility based on limited income and resources.[1] The SSI program includes both adults and children. A child, if younger than age 18, can qualify if he or she has a physical or mental condition that meets Social Security's definition of disability for children, and if his or her income and countable resources fall within the eligibility limits.[2]

Medicaid provides health coverage to eligible low-income adults, children, pregnant women, elderly adults, and people with disabilities. Medicaid recipients must meet income and resource limitations. Medicaid is a joint program of the federal government and individual states.[3] In most states, if an individual is an SSI beneficiary, he or she would be automatically eligible for Medicaid; an SSI application is also an application for Medicaid. In other states, an individual must apply for and establish his or her eligibility for Medicaid separately. The objective, therefore, is to maximize the special needs beneficiary's use and enjoyment of the gift or inheritance without causing disqualification for available public benefits.

Designing a plan that works cannot be accomplished with a broad brush. The abilities and needs of each special needs beneficiary are unique. Many will always be able to support themselves; others will not. Some have families with the financial resources to ensure complete support indefinitely; others do not. Some may benefit from

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advances in medical science; unfortunately, others will not. Some are young; some are not. Some have a strong support system; others do not. Some may benefit from future changes in the law; others will suffer.

Permissible types of trusts

Prior to Congress's enactment of the Omnibus Reconciliation Act of 1993 (OBRA '93), when faced with providing for the long-term care of a special needs beneficiary, it was common to disinherit the beneficiary. The gift or inheritance would be left to a third party, typically a family member or friend, with an informal understanding that the third party would use the funds for the beneficiary's needs.[4] Since the arrangement was informal and the beneficiary had no right to the funds, the beneficiary's eligibility for public benefits would be unaffected. The funds could then be spent on the "extras" that are not provided by public benefits.

These informal arrangements worked if everything went as planned. It was not very protective of the beneficiary, however, who had no rights in the gift or inheritance. It opened the door for possible abuse or mismanagement by the third party holding the assets. Since there was no trust arrangement, the assets were owned by the third party and could be dissipated or lost in the event of the third party's dishonesty, divorce, bankruptcy, or death. And, because the third party had no fiduciary obligation, there was little recourse for the special needs beneficiary. To provide better protection, OBRA '93 allowed individuals to qualify for public benefits with assets in one of three types of trust:

Supplemental needs trusts must also contain spendthrift provisions to prevent the beneficiary from having access to the trust's assets.

Special needs trusts. Special needs trusts[5] are created with the beneficiary's own assets so that those assets remain available for the beneficiary's use. The trust must specifically provide that any funds remaining in the trust upon the beneficiary's death are to be used to repay benefits provided to the beneficiary.[6]

Pooled income trusts. Pooled income trusts[7] are created and administered by a nonprofit entity, with the beneficiary's own assets added to his or her individual trust for use during his or her lifetime. A pooled trust contains the assets of several different individuals, maintained in separate accounts with each account having a beneficiary. The crucial distinction is between the trust established through the actions of the nonprofit association and the individual trust accounts within it, which are established by an individual or another person for the individual.[8] Upon the beneficiary's death, any unused balance retained in the pooled income trust may be used for the benefit of the other beneficiaries.[9]

Supplemental needs trusts. Supplemental needs trusts are established by a third-party and funded entirely with third-party assets by lifetime gift or testamentary bequest. They are critically different from the other two types of trusts because the beneficiary's own assets cannot be used to fund a supplemental needs trust.

The use of supplemental need trusts creates a more protective method of providing for a special needs beneficiary. That protection exists because the funds are held and administered by a trustee with a fiduciary duty to the special needs beneficiary. That fiduciary duty requires the utmost good faith and candor. A trustee is invested with rights and powers to be exercised for the benefit of another per-

1 Social Security Administration, "Supplemental Security Income," Publication No. 05-11000 (October 2017), available at www.ssa.gov/pubs/EN-05-11000.pdf.

2 Social Security Administration, "Benefits for Children With Disabilities," Publication No. 05-10026 (January 2017), available at www.ssa.gov/pubs/EN-05-10026.pdf.

3 www.medicaid.gov/medicaid/index.html.

4 Rankin, "Personal Finance; Estate Planning for Disabled Children," N.Y. Times, 1/10/1988.

5 42 U.S.C. section 1396p(d)(4)(A).

6 https://secure.ssa.gov/apps10/poms.nsf/lnx/0501120203#a.

7 42 U.S.C. section 1396p(d)(4)(C).

8 Note 6, *supra*.

9 42 U.S.C. section 1396p(d)(4)(C).

son. The fiduciary duty of a trustee allows the beneficiary to hold the trustee responsible for mismanagement of the trust funds and to compel distributions required by the terms of the trust.

Unfortunately, much confusion arises from the fact that the terms "special needs trust" and "supplemental needs trust" are often used interchangeably. The confusion is made worse because they are both often referred to as "SNTs." They are dramatically different entities. Third-party supplemental needs trusts are not required to have the repayment provisions that are required in special needs trusts. Importantly, because the assets in a third-party supplemental needs trust are not subject to repayment provisions, those assets can be held for other beneficiaries upon the death of the beneficiary with special needs.[10]

Planning considerations

To avoid being deemed a countable asset of the beneficiary for the purposes of public benefits, a supplemental needs trust must be used to supplement—and not supplant—available public benefits. When properly drafted and administered, supplemental needs trusts allow beneficiaries to remain qualified for health care coverage under Medicaid programs and for Social Security Supplemental Security Income benefits (SSI).[11] Supplemental needs trusts must also contain spendthrift provisions to prevent the beneficiary from having access to the trust's assets.[12]

The spendthrift provisions must prevent both involuntary and voluntary transfers of the beneficiary's interest in the trust income or principal. This means that the beneficiary's creditors must wait until money is paid from the trust to the beneficiary before they can attempt to claim it to satisfy debts. Also, the beneficiary cannot sell his or her right to receive the monthly payments to a third party.[13]

The trust must be able to adapt to the needs of the beneficiary as circumstances change.

While supplemental needs trusts are an important component of planning for special needs beneficiaries, they do have drawbacks, particularly when the trust is expected to continue for decades. The beneficiary's abilities, needs, and potential eligibility may change for better or worse. For example, individuals on the autism spectrum may experience very different symptoms and behavior, and due to increased understanding and improved treatments, outcomes have improved in many cases. A supplemental needs trust may be too restrictive for a beneficiary whose functional abilities have improved.

Federal legislative changes. Eligibility may also change due to changes in the law, which may alter the criteria for benefits eligibility. To illustrate, it is helpful to see some of the changes in Medicaid eligibility for seniors in skilled nursing facilities. Applicants may be disqualified for benefits if they transfer assets without consideration prior to applying for benefits. Before 1988, the look-back period for disqualifying gifts was 24 months.[14] In 1988, the look back period was extended to 30 months and again in 1993 to 36 months. The look-back period for gifts in trust was extended to 60 months.[15]

The Deficit Reduction Act of 2005 extended the lookback period for all gifts to 60 months and changed the way in which the period of disqualification was calculated.[16] Prior to 2005, the penalty always began on the date of the gift. Under the new law, the penalty period did not begin to run until either the date of the gift or the date the individual enters a nursing home and is found eligible for coverage, were it not for the gift, whichever is the later date.[17]

The clear trend is toward a tightening of eligibility criteria, ostensibly in an attempt to control the cost of benefits at the state and federal levels. The logic appears to be that making eligibility more difficult will reduce the number of recipients and that fewer people receiving public benefits will cost less money.

Uniform Trust Code (UTC). Supplemental needs trusts are also affected through the gradual adoption by states of the UTC, with 33 states having done so as of May 2017.[18] One of the overriding purposes of the Uniform Trust Code is to protect beneficiaries by ensuring that they are kept aware of facts material to the administration of a trust and to ensure that their distribution rights are enforced.[19]

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10 https://secure.ssa.gov/poms.nsf/lnx/0501120200#d.

11 https://secure.ssa.gov/poms.nsf/lnx/0501120200.

12 www.uniformlaws.org/shared/docs/trust_code/utc_final_rev2010.pdf.

13 https://secure.ssa.gov/poms.nsf/lnx/0501120200#b16.

14 https://secure.ssa.gov/poms.nsf/lnx/0501730046.

15 *Id.*

16 www.ssa.gov/OP_Home/comp2/F109-171.html.

17 www.cms.gov/regulations-and-guidance/legislation/deficitreductionact/downloads/toabackgrounder.pdf.

18 http://uniformlaws.org/Act.aspx?title=Trust%20Code.

19 http://uniformlaws.org/ActSummary.aspx?title=Trust Code.

20 www.uniformlaws.org/shared/docs/trust_code/utc_final_rev2010.pdf.

21 *Id.*

22 *Id.*

23 Engel, *Asset Protection Planning Guide*, 3rd ed. (CCH, 2013), ¶ 815.03.

Supplemental needs trusts are often designed to allow the judgment of the trustee to override the judgment of a beneficiary and to protect the trustee from having its decisions challenged. The Uniform Trust Code makes that more difficult. The concern is whether state trust law could allow a court to require distributions from a supplemental needs trust, which would disqualify the beneficiary from receiving public benefits.

Prepare for changes. To be effective, supplemental needs trusts cannot be created as static instruments. The trust must be able to adapt to the needs of the beneficiary as circumstances change. Supplemental needs trusts, however, cannot be changed by the individual who created the trust. For lifetime gifts, the funds would be transferred to an *inter vivos* irrevocable trust. For testamentary bequests, the death of the individual who created the trust makes amendment by the decedent impossible. The challenge is to design a trust that allows modification by someone other than the creator of the trust.

One possibility is to give the trustee the power to alter or amend the trust so that it continues to meet the needs of the beneficiary. But the power to amend may conflict with the trustee's fiduciary duty to the trust and its beneficiaries. This is made even more difficult when the Uniform Trust Code grants to the beneficiaries greater rights to question the actions of the trustee. The potential conflict is even more sensitive, given the fact that any modification of the trust may result in a reduction or elimination of the beneficiary's interest in the trust. The fiduciary obligations make the trustee a less-than-optimal choice.

Trust protector. Another option is to appoint a trust protector, who would have the right to modify or amend the trust. A trust protector is an unaffiliated third party who can be given the power to alter the terms of the trust in response to changes in the law or other circumstances. The concept of trust protectors is borrowed from asset protection trusts, where a trust protector may be granted certain powers, including the power to amend the trust, terminate a trustee, appoint a replacement trustee, or even terminate the trust.[20]

The UTC ratifies the use of trust protectors. A trustee must generally act in accordance with the direction provided by the trust protector, unless doing so would breach the fiduciary duty owed to the trust beneficiaries.[21]

While offering increased flexibility, the issue when appointing a trust protector is whether trust protectors also have a fiduciary obligation and may be subject to the same conflicts as a trustee. In terms of a supplemental needs trust, the UTC implies that a trust protector is a fiduciary unless the settlor provides otherwise. The trust protector is acting on behalf of others. As provided by the UTC, the power holder is "presumptively acting in a fiduciary capacity with respect to the powers granted and can be held liable if the holder's conduct constitutes a breach of trust."[22] To address this issue, a settlor can provide that the trustee must accept the decision of the power holder. Or a settlor could provide that the holder of the power is not to be held to the standards of a fiduciary.

Limited liability company (LLC). The creation of an LLC may allow indirect, albeit limited, modification of a supplemental needs trust. The trust would create and own the LLC, which would be managed by a third party. When the trustee transfers the assets of the trust to the LLC, it places those assets within the control of the LLC manager, who could be given wide discretion as to when distributions from the LLC to the trust will be made.[23] By layering the ownership of trust assets, the trustee is left powerless to make distributions for the beneficiary without first receiving a distribution from the LLC.

Non-fiduciaries. Another possible solution would be to appoint one or more individuals to act in a non-fiduciary capacity. The non-fiduciary could be given the exclusive power to direct the trustee's distributions or the power to amend or modify the trust. The problem is that

allowing an individual to act in a non-fiduciary capacity essentially creates a power of appointment.[24]

Powers of appointment require great care to ensure that neither the power itself, nor its exercise will result in tax consequences to the power holder. The non-fiduciary role must be crafted to avoid having it construed as a general power of appointment. Otherwise, the non-fiduciary would be deemed the owner of the trust assets, taxed on the trust's income, and any distribution from the trust would be deemed a taxable gift from the non-fiduciary to the beneficiary.

A power of appointment is authority to designate the recipients of beneficial interests in property.[25] A general power of appointment is any power of appointment exercisable in favor of the power holder or the power holder's estate, creditors, or the creditors of the power holder's estate.[26] One way to avoid creating a general power of appointment is to make the power exercisable only in conjunction with another person who has a substantial interest in the trust which is adverse to the power holder or who is a remainder beneficiary of the trust.[27]

Even if the non-fiduciary authority is only a non-general or limited power of appointment, the relationship between the non-fiduciaries and the beneficiary can lead to unintended income tax consequences by causing the trust to be taxed as a grantor trust to the non-fiduciary. A person who is not the grantor of a trust may be taxed as the grantor of a trust to the extent that person has the unrestricted power to withdraw the principal or income of the trust or to the extent that person applies the trust assets to satisfy that individual's obligation of support.[28]

For these reasons, it may be better to include other permissible beneficiaries of the trust and not to vest the non-fiduciary authority in a single person, but to select a group of people with interests in the trust that are adverse to each other.[29]

Using non-fiduciaries in a supplemental needs trust may allow much greater flexibility to adapt to changed circumstances than would be possible with a trust protector or with a trustee power to amend. By definition, a non-fiduciary does not have a fiduciary obligation to the trust beneficiary. This will make it inappropriate for many families, since it essentially gives one or more third parties the authority to alter their estate plan. Relinquishing that control is difficult and demands an abundance of confidence in the ability, judgment, and integrity of the individuals with the non-fiduciary authority.

Objectively, this harkens back to the days before OBRA '93, as in a manner of speaking, this is a return to the past. It places a great amount of faith in a third-party non-fiduciary, who is trusted to act in the best interests of the beneficiary. There is added protection for the beneficiary, but it still represents a level of informality and tacit understanding.

That informality and lack of fiduciary obligation means that incorporating a non-fiduciary is clearly not as protective of the beneficiary as is using a trustee. The benefit of fiduciary obligation is that it protects the beneficiary from any intended or unintended actions or inactions of the trustee that negatively affect the beneficiary's rights. On the other hand, that fiduciary obligation tends to limit the flexibility of the trust, potentially rendering it less protective to the beneficiary for purposes of public benefits eligibility. One solution might be to "split the risk" and create a supplemental needs trust with non-fiduciary authority over a part, but absolute fiduciary control over the rest. Ultimately, practitioners should assess the unique needs, abilities, and resources of each beneficiary to determine the correct approach, balancing security with adaptability.

Conclusion

Supplemental needs trusts can improve the financial positions of individuals who have special needs. Care should be taken in drafting the trusts, however, to meet the specific needs of the beneficiary and to allow the trusts to supplement rather than take the place of public benefits for which the beneficiary may be eligible. Including provisions that offer flexibility to accommodate changing circumstances is also a desirable goal. ■

[24] IRC Section 2041

[25] Restatement (Second) of Property: Donative Transfers Section 11.1 (1986).

[26] Reg. 20.2041-1.

[27] Reg. 20.2041-3(c).

[28] Sections 678 and 2035.

[29] Section 2514.