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Special Needs Trusts Increase the Quality of Life and Preserve Entitlement Eligibility

By David J. Gordon, CIMA®, CFP®

The special needs trust (SNT), also known as a supplemental needs trust, is a statutory creation used primarily to protect and optimize the financial planning opportunities of people with physical or mental disabilities otherwise meeting the Social Security aid requirements. This article discusses trusts created under the Omnibus Budget and Reconciliation Act of 1993 (OBRA).¹

Special needs trusts are an important exception to the typical rules that apply to most trusts. During the life of the beneficiary, properly designed and implemented SNTs can shelter assets from needs-based programs such as Medicaid and Supplemental Security Income (SSI). Moreover, for persons under age 65, an irrevocable OBRA ’93 SNT will not be subject to the “look-back” rules. These rules, designed to prevent gratuitous transfers for the sole purpose of aid qualification, consider “available resources” to include those transferred within 36 months for transfers to individuals, and five years for transfers to trusts.

Applications for most needs-based public assistance consider the typical trust as an available resource. This is not the case with SNTs, which are specifically exempt in that regard. At the death of the beneficiary, the public agency usually will have a lien against the trust to recover funds provided. However, while alive, the beneficiary will have the added security and flexibility of available trust assets to “supplement” the quality of life and care.

Needs-based programs generally are subject to asset and (sometimes) income thresholds that can disqualify or require contribution from those with even very modest financial resources. These types of programs form a long list, and also may include food stamps, Veterans Administration benefits, Medicare Part D, state and county benefits, legal and health clinics, and services or financial aid from other public or private organizations. They are distinguished from entitlement programs such as Medicare and Social Security Disability Insurance (SSDI), where qualification requires only requisite work-related tenure on the part of the recipient or parent.

Three Basic Formats

There are three main types of SNTs. They feature different funding sources and varying payback requirements. They are distinguished mainly by their ability (or not) to direct residual amounts, and whether creditors can attach or seek repayment from trust assets. When using trust formats differing from the SNT, great care should be taken to assure there is no conflict with needs-based entitlement programs. Although it is possible that a trust, properly drafted and funded with assets not owned or entitled to by the disabled individual and settled by a third party, could be exempt from consideration, it is not a simple matter and can vary from state to state. It is strongly recommended that qualified counsel, experienced in SNTs, be consulted before embarking on any action that may have legal or tax consequences.

First-Party SNTs

Practitioners commonly use the term “special needs trust” to designate trusts that are funded by assets belonging or awarded to the disabled individual. To shelter assets from needs-based eligibility guidelines, these trusts require reimbursement to the state agency from residual trust assets at the death of the disabled individual beneficiary. Amounts remaining after repayment, if any, may be distributed per the terms of the trust. These so-called “payback” trusts arise from 42 U.S.C. 1396p(d)(4)(A) and (d)(4)(C), and also may be referred to as “(d)(4)(A)” or “(d)(4)(C)” trusts.

Note that the (d)(4)(A) type of SNT must be for the sole benefit of the disabled individual, must be funded before the individual is age 65, and cannot be created directly by the disabled individual—even if that person has the capacity to do so. "A trust containing the assets of an individual under age 65...

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who is disabled (as defined in section 1382c(a)(3) of this title) and which is established for the benefit of such individual by a parent, grandparent, legal guardian of the individual, or a court. The state will receive all amounts remaining in the trust upon the death of such individual up to an amount equal to the total medical assistance paid on behalf of the individual under a state plan under this subchapter.” 42 U.S.C. 1396p(d)(4)(A).

**Third-Party SNTs**

Third-party SNTs are trusts that are funded and settled by a third party with assets not belonging to the beneficiary. Authorized under the individual states’ trust or trustee statutes, careful drafting is important to best assure that distributions do not conflict with or reduce Medicaid and other needs-based programs.

As in the case of other SNTs, the third-party supplemental needs trust is designed to improve the quality of life for the individual, and to be an “exempt asset” for the purposes of needs-based eligibility programs. At death, assets remaining in this type of trust are not subject to state agency repayment. Instead, the designated beneficiaries are entitled to the assets as specified under the terms of the trust. These trusts can be very useful in properly drafted estate plans and in conjunction with inter vivos gifting goals. As with any tax or legal matter, qualified counsel should be consulted.

**Pooled Trusts**

A third type of SNT is referred to as the “pooled trust” because contributions are commingled or “pooled” for investment purposes. Each individual beneficiary is a disabled person and has a subaccount that determines and tracks the amount of assets he or she is entitled to use.

Enabled by 42 U.S.C. 1396p(d)(4)(C) and established by a “joiner agreement,” the (d)(4)(C) trust has no age limitation. Unlike (d)(4)(A) trusts, the pooled trust can be used to shelter assets of disabled individuals over the age of 65. It can be established by a parent, grandparent, guardian, court, or by the disabled individual (with requisite capacity). In addition to protecting assets from spending down to qualify for aid, other advantages may include convenience, fiduciary oversight, cost-effective investment management, ease of administration, and inexpensive establishment and maintenance costs.

At the death of the beneficiary, some states will seek repayment for sums expended, while other states allow funds to stay in the pool or to be otherwise directed. There is a great deal of latitude because the OBRA regulations allow up to 100 percent of the residual to be retained by the trust. However, federal law also allows the individual states to provide their own more restrictive requirement, resulting in significant variance across the country.

Still in conformance with federal law, Illinois is an unusual example that currently requires payback to the state only if sufficient funds remain for a 100-percent payback, i.e., trusts with lower residuals are not subject to payback at all. Subject to the 100-percent payback requirement, Illinois also allows the entity creating the trust to retain a fixed percentage. Remaining funds, if any, may be transferred to designated beneficiaries or donated back to the trust, if so desired.

For example, Illinois allows immediate Medicaid eligibility for a person over age 65 who shelters assets with a pooled trust. Rules can vary state by state, however, because Medicaid, although authorized by the federal government, is implemented at the state level. Many states have a post-age-65 penalty for uncompensated transfers (where fair market value is not received by the transferor from the trust). The penalty can require amounts paid out to be first used to offset all or part of the Medicaid costs incurred prior to qualification (for Medicaid).

As with all Medicaid and state-provided entitlement programs, it is important to check your specific state regulations for guidance. In addition to state-by-state rules, variances exist among different trusts within the same state. As a result of this disparity, it can be economically beneficial to compare different trusts before embarking on a course of action.

**The Miller Trust**

Only relevant in states with “income-cap” rules where (d)(4)(B) trusts are used, certain entitlement programs may not provide for nursing facility expenses and also will not allow individuals to spend down to qualify for Medicaid facility payments. Income-cap states currently include Alabama, Alaska, Colorado, Delaware, Idaho, Mississippi, Nevada, New Mexico, Ohio, South Dakota, and Wyoming. In addition, income limitations also can impact Medicaid and other needs-based programs.

In the income-cap states, one method to solve this issue is known as the “qualified income trust” (QIT) or “Miller trust.” The QIT can be established to receive the amount of income in excess of the income cap. Enabled by 42 U.S.C. 1396p(d)(4)(B) and an offshoot of Miller v. Ibarra, 746 F. Supp.,
19 (D. Colo. 1990), this irrevocable trust may provide Medicaid eligibility in cases where it would otherwise be denied. Income from annuities, pensions, government assistance, and other sources is paid into the trust and distributed in the month in which it is received. No assets, other than income, may be contributed to a Miller trust. In the case of annuities, where distributions are considered part principal and part income, the principal portion cannot be contributed to the Miller trust.

The Miller trust can provide the settlor with a monthly income, so long as the total from all sources is below the threshold amount. In certain states, additional sums may be paid to the spouse of the beneficiary, again assuming that total spousal income remains below the cap amount. Additional income is then paid to the care provider, often a nursing home, to offset the Medicaid cost. At the death of the beneficiary, any remaining funds are used to reimburse the Medicaid agency. Again, rules vary by state and should be carefully considered before taking action. Although many state Medicaid agencies have pre-approved trust forms and/or guidelines, they will usually not provide tax or legal advice.

Thoughts for the Future

Beyond maintaining eligibility for benefits, an SNT also may include a care plan or memorandum of intent to help an incoming trustee understand the goals of the settlor insofar as quality of life and treatment needs may be concerned. Also referred to as a life plan and designed to communicate the wishes and knowledge of the parent or caregiver, it can help future caregivers understand the history of the disabled individual. In addition to medical and disability-related directions, a life plan can describe preferred living arrangements, friendship relationships, favorite places, comfort foods, likes and dislikes, etc.

An SNT can help maintain and improve quality of life and protect the individual from the stress and disruption that can accompany changes in primary caregivers and trustees. Drafting a life plan can help everyone and can be elaborate and highly structured, or as simple as a hand-written statement of a parent’s wishes for the child. Many private and nonprofit resources exist to help guide the creation of the plan and explore available options. With modest forethought, difficult transitions can be made easier and outcomes more successful.

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Endnote

1 The trusts are codified in 42 U.S.C. § 1396p(d)(4)(A), et. seq., and Third Party Trusts. SNTs may also be referred to as “OBRA 93 Trusts,” “d4A” or “d4C” trusts and Third-Party Trusts. In Illinois, relevant statutory authority is found at 760 ILCS 5/15.1; 305 ILS 5/5–1.1a, 405ILCS 5/5-105, and 89 Ill. Admin. Code Sect.120.347.

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