Special Needs Planning and Personal Injury Settlements

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I. Special Needs Planning Generally

A. Introduction - The Problem

Disabled persons often have certain needs that they are unable to accommodate, creating the need for someone else to care for them. Oftentimes, that someone is a parent or other family member. But what happens when the parent or other family member is no longer around or no longer able to provide the necessary care? Several issues unique to special needs persons must be addressed in the planning process to ensure that the disabled person always receives the level of care that he or she needs, such as: 1) how and by whom will the disabled person be taken care of during their life, 2) what standard of care will the disabled person receive, 3) what financial resources (which can include resources of the disabled person's family, government benefits, and resources that the disabled person may have in their own name) will be available to be used for the disabled person, 4) how will taxes affect the disabled person's resources, and 5) does the plan for the disabled person have enough built-in flexibility to accommodate potential changes in resources, fiduciaries, and the law.

B. General Estate Planning Considerations for Disabled Persons

The estate planning attorney is guided by two things when assisting a client with their planning, one being what the client wants to accomplish and the other being how the law impacts what the client wants to accomplish. It is important to balance the two in a way that properly assists that client, always leaning toward the side of what the client wants. However, the attorney needs to properly educate the client about the law and the attorney's experience with other similar cases so that the client can make informed decisions about their planning.

There are essentially four choices for families planning for a member with a disability, whether the family member be a child, sibling, parent, or other family member:

1. Outright Gift

The family can leave outright gifts to the disabled person. However, by doing so the family may be making the disabled person ineligible for government benefits. The family may also be creating a danger to the disabled person by giving them unfettered access to money or other assets. Also, the case where the parents leave their estate equally to their children and one of their children is disabled could result in the disabled person being a partner with the other children in non-cash assets such as real estate or a family business.

Outright gifts could be appropriate in rare cases where the disability is physical in nature (as opposed to mental or emotional) and does not inhibit the disabled person's ability to conduct their financial affairs appropriately. Outright gifts seem to be the ultimate result in most cases where the families have not undertaken estate planning.

2. Disinherit

The family can disinherit the family member that has the disability. At first glance this appears to be a very good option because it removes the issue of the disabled person having assets in their own name and it removes the issue of having to appoint an appropriate fiduciary to take care of the disabled person. The obvious problem with this choice is that there are no assets that anyone would be required by law to use for the benefit of the disabled person. This approach also must necessarily assume that government benefits or gifts will always be available and sufficient to take care of the disabled person, and such assumption may or may not always be accurate.

3. Morally Obligated Gift

The family can create an informal trust arrangement by leaving a gift to a family member who has agreed that they will take care of the disabled person. The financial welfare of the disabled person in this case rests on the moral obligation of the family member that agreed to provide the care. This approach does not properly consider other matters that could directly affect the disabled person's welfare, such as the divorce, disability or liability of the family member that received the assets which were to be used for the disabled person. In any of those instances the gift that the parents or care takers intended for the disabled person can be lost, leaving the disabled person without resources to take care of them.

4. Special Needs Trust

The special needs trust can address virtually all of the issues related to planning for a disabled person. The only issue that clients seem to struggle with is the selection of appropriate fiduciaries. However, that issue is often overcome after some thoughtful discussion and consideration. The special needs trust essentially provides for the disabled person during their lifetime while preserving their eligibility for government benefits, with any remaining assets either being used to pay back the state Medicaid program or passing to the disabled person's descendants or the grantor's descendants. While historically there may have been many varieties of special needs support or discretionary trusts, there are currently four predominate special needs trusts being used, which are: 1) the supplemental needs trust or third-party trust, 2) the (d)(4)(A) special needs trust, 3) the income trust, and 4) the pooled trust.

C. Different Types of Special Needs Trusts

1. Supplemental Needs Trust (SNT) (See Appendix A)

This type of special needs trust is also referred to as a third-party trust because the trust is established and funded by someone (the third-party) other than the disabled person. The trust is irrevocable and essentially provides that assets in the trust are to be used for the benefit of the disabled person. Upon the death of the disabled person the assets will pass to whomever the grantor directs in the trust. The assets are to be used for the disabled person after all available government benefits have been exhausted. The important point with this type of trust is that when the disabled person dies the trust does not have to pay back the state for any Medicaid benefits that the state may have paid on behalf of the disabled person.

A supplemental needs trust can be appropriate for disabled persons under age 65 or over age 65. The objective is to send assets to a trust before the disabled person receives them so that the receipt of the assets does not disqualify the disabled person for government benefits that they are already receiving or that they may need to receive in the future. Supplemental needs trusts may be either established in someone's will as a testamentary trust or established upon execution as an *inter vivos* trust. Generally, for disabled persons under age 65, it is preferred to establish an *inter* *vivos* trust that would be available to receive funds from family members and friends. Once established, the trust would also be available to be named as a beneficiary of life insurance.

An example of an *inter vivos* supplemental needs trust is set forth in Appendix A for illustration purposes only. Anyone who chooses to use it as a form document should conduct their own research before using the document for their particular special needs matter.

The name to use for the trust should not include the disabled person's name because, while the assets are intended to benefit the disabled person, the trust is designed to receive and administer assets that never technically belonged to the disabled person (as opposed to the (d)(4)(A) trust described in detail below). The rationale behind this position is that any reference to the disabled person's name in the name of the trust may confuse the issue of whether the trust is required to reimburse the state Medicaid office after the disabled person passes away. The typical name to use for the trust is the family's name. For instance, it could be called the "Smith Family Special Needs Trust." Additionally, for practical drafting purposes it is helpful to reserve the trust name which uses the disabled person's name for a (d)(4)(A) trust, should that type of trust be or become necessary.

While the general rule is that third-party supplemental trusts are not required to reimburse the state for Medicaid payments, the trust must be carefully drafted so that the third-party grantor's intent is clear that the trustee does not have a duty to support the beneficiary. Otherwise, it is conceivable that a court could deem such mandatory support payments as countable assets to the disabled person and require reimbursement to the state for benefits which the state provided.[1]

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[1] *See Rosenberg Est. V. Dep't of Public Welfare*, 679 A.2nd 767 (Pa. 1996), *aff'g* 664 A.2nd 215 (Pa. Commw. 1994).

However, the greater likelihood appears to be that the courts will look to the intent of the third-party when the trust was established and generally hold that a third-party trust is not liable to the state for reimbursement.[2] The client should be apprised of the possibility, albeit remote, that the trust may not withstand an attack by a government benefit provider.

2. (d)(4)(A) Special Needs Trust ((d)(4)(A) Trust) (See Appendix B)

This type of trust is designed to hold and administer assets which belong to the disabled person, while maintaining the disabled person's eligibility to receive government benefits such as SSI and Medicaid (which are discussed in more detail below). Such assets can come from any number of sources, such as assets which the disabled person acquired on their own by working (if they were at one time able to be gainfully employed), or through some form of inheritance, or through a personal injury court settlement or judgment. The trust must be initially funded with the disabled person's assets, but thereafter the trust may also receive assets from other sources. This trust is virtually always set up as an *inter vivos* trust, since the objective is to qualify the disabled person for government benefits immediately and transfer assets which the disabled person already owns.

An example of an *inter vivos* (d)(4)(A) special needs trust is set forth in Appendix B for illustration purposes only. Anyone who chooses to use it as a form document should conduct their own research before using the document for their particular special needs matter.

The statutory approval for this type of trust comes from 42 U.S.C. § 1396p (d)(4)(A), as amended by the Omnibus Budget Reconciliation Act of 1993. Section 1396p (d) essentially sets

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[2] *See Lineback by Hutchens v. Stout*, 339 S.E.2nd 103 (N.C. App. 1986). Also see Moore and Landsman, 816 T.M., *Planning for Disability*, p. A-47.

forth cases in which transfers to a trust may not be used to qualify a person for benefits. Section 1396p (d)(4)(A) then sets forth an exception to that rule, provided the following three requirements are met:

a. The trust is established for the benefit of an individual under age 65 who is disabled (as defined in 42 U.S.C. § 1382c (a)(3));

b. The trust is established by a parent, grandparent, legal guardian of the disabled person, or a court; and

c. 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.

While all the funds remaining in the (d)(4)(A) trust after the disabled person's death may be needed to reimburse the state for benefits provided, residuary provisions should be included in the trust because it is conceivable that funds could be left over after the state is reimbursed. Whether funds remain after the state is reimbursed depends on the amount of assets placed in the trust and the amount that was ultimately paid by the state on behalf of the disabled person, which is often influenced by how long the disabled person lived after starting to receive state benefits. The most typical residuary provisions provide that the funds would pass, after state reimbursement, to the persons who would take as heirs if the disabled person were to die without a will.

The statute does not mention any dollar limit to the amount that can be transferred into the trust, and there does not appear to be any rule of thumb or set guideline to how much disabled persons may need for their care. The general consensus is to make as many resources as possible available for the benefit of the disabled person. Therefore, it is not unusual to place very large settlements (in excess of $1,000,000) into (d)(4)(A) trusts and then apply for needs-based government benefits.

As mentioned above, a parent, grandparent, legal guardian, or a court can establish the trust. The statute does not require that a court be involved if the other requirements are met. However, it is generally better to seek court approval to bolster the case that the trust has been set up properly. Being able to show the government benefit provider that the court has given the trust and its fiduciaries the court's blessing goes a long way in passing through the process of obtaining government benefits. Also, during the court approval process the petitioner and court have the opportunity to address whether a conservator, legal guardian, and/or bond are needed. One other important reason to seek the court's approval is that in many cases the family has employed a life planner or case worker to assist them in budgeting the expenses related to the disabled person. The life planner or case worker normally prepares a comprehensive management plan which provides for payments to be made from the trust (or from the funds of the disabled person prior to funding) which qualify as allowable payments. Having the court bless the management plan makes it much easier to justify the payments when working with the government benefit provider.

In addition to the benefit to the disabled person, the (d)(4)(A) trust can actually be used to benefit the parent of the disabled person. Section 1396p (c)(2)(B)(iv) provides that the assets of a person may be transferred to a (d)(4)(A) trust without making them ineligible to receive government benefits. The most likely scenario is where a parent has previously set up a (d)(4)(A) trust for their disabled child and later the parent needs government benefits for nursing home care and does not want to use up their assets because their assets may be needed for the disabled child.

The parent, or his or her agent under a power of attorney, or conservator can transfer the parent's assets into the child's (d)(4)(A) trust and, assuming the parent is otherwise eligible, make the parent eligible to receive Medicaid for nursing home care.

3. <u>(d)(4)(B) Special Needs Income Trust (Income Trust)</u>

This type of trust is used in the case where a person is disqualified from government benefits because he or she is receiving too much monthly income. The trust is designed to receive the income that exceeds the allowable amount (the allowable amount is discussed in more detail below). The trustee of the trust receives the excess amount and then simply pays it over to the state. The person then becomes eligible to receive benefits. When the person dies the state looks at how much in benefits were provided, and if the money received from the person's trust exceeds the benefits provided, the state will refund the difference. A careful analysis needs to be made to determine if the net result is worth the trouble of setting up the income trust. Generally, the monthly income amount needs to be more than the allowable amount to receive government benefits, but less than the monthly amount needed for care, whether such care be institutional care or home care which qualifies under some sort of waiver program of the state (waiver programs are discussed in more detail below). This trust is also sometimes referred to as a Miller Trust.

The statutory approval for this type of trust comes from 42 U.S.C. § 1396p (d)(4)(B). The trust must be composed only of pension, Social Security, and other income to the individual (and accumulated income in the trust), and the state must 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.

The income trust is primarily used for persons over the age of 65 who need nursing home care. It is possible for the trust to be used for disabled persons under age 65, however, normally persons under the age of 65 do not have any recurring monthly income to consider in the planning process. The South Carolina Department of Health and Human Services, who administers the State Medicaid program, has developed a standard income trust form which is made available on the internet at http://medsweb.clemson.edu/formslisting.htm. Form ID #905 includes the trust agreement. It may also be helpful to review Form ID #s 907, 925, and 926. This trust is virtually always set up as an *inter vivos* trust, since the objective is to qualify the individual for government benefits immediately and transfer income that the individual is already receiving.

4. <u>(d)(4)(C) Pooled Special Needs Trust (Pooled Trust)</u>

This type of trust is designed to hold and administer assets which belong to the disabled person, while maintaining the disabled person's eligibility to receive government benefits such as SSI and Medicaid. The term "pooled" comes from the concept of adding the funds from many similarly situated disabled persons, such as a certain type of injury or disability, and pooling them together to enjoy the investing power of a greater amount of assets and the benefits of a centralized and more streamlined management of assets. Normally the association handling the funds will provide the form documents for the family of the disabled person to execute.

The statutory approval for this type of trust comes from 42 U.S.C. § 1396p (d)(4)(C), which provides that the trust must:

a. Be established and managed by a non-profit association;

b. Maintain a separate account for each beneficiary of the trust, but, for purposes of investment and management of funds, the trust pools these accounts;

c. Establish accounts in the trust solely for the benefit of individuals who are disabled (as defined in section 1382c (a)(3) of this title) by the parent, grandparent, or legal guardian of such individuals, by such individuals, or by a court; and

d. To the extent that amounts remaining in the beneficiary's account upon the death of the beneficiary are not retained by the trust, the trust pays to the state from such remaining amounts in the account an amount equal to the total amount of medical assistance paid on behalf of the beneficiary under the state plan.

5. Trustee Selection and Governance

Since neither federal nor South Carolina law restricts who can serve as trustee of the trust, the trustee and successor trustees may be chosen at the discretion of the person or entity establishing the trust. The trustee (and successor trustees) of the special needs trust need to be carefully chosen because the trustee will be charged with providing the disabled person with the unique care that they deserve. The trustee will be required to employ sound judgment in their decision making and will need at least some knowledge or experience with financial matters. The trust will most likely own investable assets for which the trustee will be responsible to invest. An individual, such as a family member or friend, or a professional, such as a bank or trust company, can serve as trustee.

a. Individual Trustee

The advantages of an individual trustee are that the individual may have a history with and personal knowledge of the disabled person that would be beneficial, along with a personal interest in the care that the disabled person receives. Also, individual trustees generally tend to be less expensive than professional trustees. The disadvantages to having an individual trustee are that the assets of the trust could be viewed by the family member as family assets and not assets to be used only for the disabled person. Another possible disadvantage is that in the case where the individual trustee or someone related to the individual trustee has a potential remainder interest in the trust assets after the disabled person dies (which is particularly the case where the trust is not required to reimburse the state for Medicaid payments), the individual trustee may not always spend the trust assets for the benefit of the disabled person in the fashion that the grantor intended.

b. Professional Trustee

The advantages to using a professional trustee are that a professional trustee normally has more particular knowledge and experience in handling trust, financial, and special needs matters than an individual trustee has. The professional trustee would also have a more objective and unbiased approach to administering the trust assets than would an individual trustee. However, there are disadvantages to having a professional trustee. Along with generally being more expensive than an individual trustee, another disadvantage is that a professional trustee may require that the amount of trust assets be at least the amount of their minimum standard of, for example, $1,000,000 or higher, making it difficult to first qualify and later to maintain such amount as trust funds are reduced through payments for the benefit of the disabled person.

Assuming that the minimum standards are met, a compromise between using an individual trustee and a professional trustee could be reached by having an individual serve as trustee with a professional trustee appointed as co-trustee, special trustee, or trust protector.

The above discussion has limited application to pooled trusts because such trusts, which generally consist of a large group of smaller trusts similarly situated, may restrict who can serve as trustee.

c. Statutory Rules Governing Trustees

The South Carolina Trust Code (SCTC)[3] provides that trust terms, which include trustee provisions, will prevail over the provisions of the SCTC, except in matters set forth in Section 62-7-105 of the SCTC. More particularly, the statutory provisions relating to trustees that will prevail over the terms of the trust include the following:

i. The duty of the trustee to act in good faith and in accordance with the purposes of the trust.

ii. The power of the court under Section 62-7-708(b) of the SCTC to adjust a trustee's compensation specified in the terms of the trust which is unreasonably low or high.

iii. The effect of an exculpatory term under Section 62-7-1008 of the SCTC. This Section essentially provides that any exculpatory language will be disregarded 1) to the extent that a trustee commits a breach of trust in bad faith or with reckless indifference to the purposes of the trust or interests of the beneficiaries, or 2) in the case where the exculpatory clause was inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the grantor or settlor.

The SCTC, in Section 62-7-804, also sets forth its version of the well known prudent investor rule. However, this standard of care provision can be modified so long as it is consistent with Sections 62-7-105 and 62-7-1008 (as discussed above).

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[3] The South Carolina Trust Code was enacted into law on May 23, 2005 and became effective January 1, 2006. It is set forth in Article 7 of Title 62 of the South Carolina Probate Code.

D. General Estate Planning Considerations for Disabled Persons Over Age 65

Generally, four primary things apply to persons over age 65 that most often do not apply to persons under age 65, such as: 1) the person over 65 is most likely receiving social security benefits which must be taken into account when considering needs-based government benefits, 2) disabled persons over age 65 frequently require some sort of assisted living or nursing home care that takes them out of their household, 3) disabled persons over age 65 no longer have their parents to care for them, and 4) people over age 65 may be entitled to certain government benefits (which may be more specific to illnesses or conditions caused by old age) which persons under age 65 are not entitled to. As mentioned above, while this outline has some applicability to persons over age 65, its main focus is on special needs matters related to persons under age 65.

II. How to deal with Personal Injury Settlements for Special Needs Beneficiaries

A. Whose Assets Are They Anyway?

Settlement or judgment awards from personal injury cases may consist of an award for the injured person and for the family or other people who were otherwise affected by the injury. For instance, in the case where an infant is delivered incorrectly in a way that caused permanent damage, an award may consist of damages for the injured child and damages for the parents who had to endure the trauma and pain associated with the injury. In that case, the award for the parents would belong to the parents and would not be counted as an asset of the child for eligibility purposes for certain government benefit programs[4], while the award for the child would be considered an asset of the child for eligibility purposes. Planning for the child's award must be done to ensure that the

[4] As noted below in the government benefits section, some benefit programs count the assets of the parents toward the child's assets and others do not.

award does not disqualify the child for government benefits that he or she would otherwise be entitled to. Actually, planning for the award or potential award for the child should start before a settlement or judgment is obtained, to expedite the period in which the award can be put to use.

Award proceeds are received subject to a lien in favor of Medicaid for the amount of benefits in which Medicaid paid prior to the award being paid. Often times, the injured party does not have the resources to pay the medical bills associated with the injury and any subsequent follow-up medical care which is necessary before the award is obtained through the courts. The Medicaid lien must be repaid prior to funding the trust. As mentioned above, with lump sum awards, the most appropriate trust to use for the award is the (d)(4)(A) special needs trust. Once the initial Medicaid lien is paid, the trust would be funded and administered for the disabled person during their lifetime. When the disabled person dies, the trust would then be required to reimburse Medicaid for the benefits provided since the time the original lien was satisfied.

Despite the imposition of the lien, the special needs trust generally results in more benefits to the disabled person. For instance, Medicaid generally pays less for medical services than an individual would pay when charged on the open market. Additionally, Medicaid does not charge interest on its lien, meaning, in essence, that the disabled person receives an interest free loan.

B. <u>Award Options</u>

The settlement or judgment award is normally paid out in one of two different ways. The most common is the lump sum, where the award amount is simply paid in full all at one time. The other way is through periodic payments through either a structured settlement paid directly by the defendant in the case or paid by an insurance or annuity company from whom an annuity was purchased by the defendant. Generally, a lump sum award payment is better in special needs cases.

The personal injury attorney needs to seek competent advice about how the award can best benefit the disabled person before the award is paid. There are a number of resources available to the attorney, including other attorneys that specialize in disability planning, private case workers, or, what seems to be the best, a certified or chartered life planner. In most cases, the personal injury attorney is highly skilled in the area of litigation but does not possess the necessary knowledge or skills in the special needs area. Other resources, such as a life planner, can work with the family and the local probate court to establish a life plan and management plan that addresses the specific needs of the disabled person. The life planner can also advise the family of all the benefits that may be available for them.

III. Government Benefits

The only reason for establishing a special needs trust is to create, maintain, or preserve a person's eligibility for government benefits. The reason for this is that the cost of caring for a disabled person can be quite expensive and unpredictable. The objective is to make as many resources as possible available for the disabled person. If there were no issue of government benefit eligibility, a standard support or discretionary trust could be set up for a beneficiary.

There are two general categories of government benefits:

A. Social Security, Medicare, and Social Security Disability

Social Security and Medicare are benefits in which a person has previously paid for and is entitled to regardless of need. These assets are in essence a retirement plan that the federal government forces its citizens to participate in. Although the government does not seek reimbursement for these benefits, they will need to be taken into account when a person seeks needs-based government benefits.

Social Security Disability is an entitlement program that employees and employers pay for with Social Security taxes. Eligibility is based on work history and the amount of benefits is based on earnings. The beneficiary's assets and income do not reduce the benefits or eligibility, except in the case where the beneficiary receives more than a minimal amount of monthly income, which would indicate that the beneficiary is no longer disabled and no longer in need of disability benefits.

B. Supplemental Security Income (SSI) and Medicaid

SSI and Medicaid benefits are the benefits in which a person is seeking to obtain when using a special needs trust. These benefits are needs-based. The recipient must demonstrate that he or she does not have too much in either assets or gross monthly income to qualify for these benefits. The limits vary with each program. The Medicaid program includes several specific programs within its purview, and many of the specific programs have their own special requirements. These benefits are governed by both federal and state laws, and one state's laws may vary greatly from another state's laws. Essentially, the benefits are federal benefits which are administered through the local state agency. SSI is administered through the South Carolina Social Security Administration office. The agency which administers Medicaid for South Carolina is the South Carolina Department of Health and Human Services (SCDHHS). States generally issue a manual which details the benefits and requirements. The SCDHHS Medicaid Policy and Procedures Manual can be found on the internet at http://medsweb.clemson.edu/mppm/ mppmtoc.htm.

To receive SSI, a person must demonstrate that he or she has no more than $2,000 in assets, is receiving no more than $623.00 per month[5], and falls into one of the following three categories:

1. Age 65 or older;
2. Blind; or
3. Disabled.

The test for disability is essentially the same as that discussed in the (d)(4)(A) trust section above for Social Security disability benefits.[6] The important point here is that once a person is deemed disabled for SSI purposes, he or she is automatically deemed disabled for Medicaid purposes. Therefore, a person on SSI would automatically receive a Medicaid card.

If a person does not qualify for SSI, he or she may still qualify for Medicaid. In that case, the requirements to qualify for Medicaid would be slightly different than the requirements to qualify for SSI. There are generally two ways in which a person can qualify for Medicaid when he or she does not qualify for SSI. They are: 1) through something similar to that for SSI for a person over age 65, blind, or disabled, or 2) through a state waiver program. For Medicaid purposes, in the case where a person is over age 65, blind, or disabled, such person can have up to $4,000 in assets and gross monthly income in the amount of $851 (plus a customary $50 disregard amount).

Waiver programs are where the state has been granted the ability from the federal government to set its own criteria for eligibility. Waiver programs are specific to certain kinds of

[5] The SSI income limit for couples is $934. These SSI income limits change in January of each year.

[6] 42 U.S.C. 1382c (a)(3).

disabilities or illnesses, such as mental retardation, head and spinal cord injury, AIDS, and autism (which is included under the general heading of pervasive developmental disorders). To become eligible under a waiver program it must be demonstrated to SCDHHS that the person has no more than $2,000 in assets and receives no more than $1,869[7] in gross monthly income. A person can be over age 65 or under age 65 and qualify for a waiver program.

If a disabled person is 18 years of age or younger and does not fit within a waiver program because his or her parents have too much income or assets, there is another program that exists for them. The Katie Beckett program (also known as TEFRA) is designed for children that, except for the parents' resources, otherwise meet the standard requirements for eligibility (which are the ones for Medicaid for persons age 65, blind, or disabled). The only difference in this program and the standard Medicaid program is that the disabled person can have income up to $1869 instead of only $951 (as is allowed under the waiver programs).

The best way to navigate through the murky waters of eligibility for government benefits is to find a friendly contact at the local government agency. Attached as Appendix C is a contact list for employees of the SCDHHS who deal with matters related to the topics discussed herein.

IV. Tax Issues

During the planning process clients should be advised of the different tax consequences related to the establishment of a special needs trust. The primary tax issues to discuss with the clients are how the trust, the grantor, and beneficiary of the trust will be taxed for income tax

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[7] This amount represents three times the maximum SSI gross monthly income limit. It changes as the SSI limit changes in January of each year.

purposes, and whether the funding of the special needs trust will create any adverse estate or gift tax consequences.

Income generated by the assets in a special needs trust can be taxed at one of three income tax rates, the trust tax rate, the individual tax rate of the grantor[8], or the individual tax rate of the beneficiary[9]. The income tax consequences can vary greatly depending on which tax rate applies[10]. Trust income which is distributed to or on behalf of the beneficiary would generally be taxed at the beneficiary's individual tax rate. Therefore, if the situation permits, the easy way to have the trust income taxed at the beneficiary's rate (which is normally the lowest rate of all the alternatives) is to distribute all the trust income out each year to or for the benefit of the beneficiary of the trust. However, the trust distributions must be limited by an amount that would not disqualify the beneficiary for government benefits (which could be taken care of by investing the trust assets in a way that the income generated is equal to or substantially equal to the budgeted payments for the beneficiary).

It is usually helpful to treat the special needs trust as a separate tax entity (with its own federal tax identification number), especially when the trust income is taxed at the beneficiary's income tax rate. This way the income from the trust can be shown as separate income on the

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[8] The grantor trust rules appear in Sections 671-679 of the Internal Revenue Code of 1986, as amended (IRC), and essentially provide that if a person has certain rights under the trust terms then such person is deemed to be the owner of the trust for income tax purposes; which means that any income taxes due from trust assets would be paid by such person at their individual tax rate. Great care should be taken when these rules are used because the use of certain grantor trust rules could cause adverse estate or gift tax consequences.

[9] IRC § 678.

[10] For individuals the highest tax rate is reached at $250,000 of taxable income, while trusts reach the highest tax rate at $7,500 of taxable income. See IRC § 1

beneficiary's Form 1040 U.S. Individual Income Tax Return. Sometimes the benefits eligibility worker will not look beyond the face of the 1040 and differentiate countable income from possibly exempt income earned by the special needs trust but not distributed to or for the benefit of the beneficiary. Separating countable income from exempt income on the 1040 would make it easier to ensure that the income generated in the trust which is not distributed to or for the benefit of the beneficiary is not counted as income to the beneficiary for eligibility purposes.

Most payments received as the result of a personal injury suit are not subject to personal income tax[11]. This exclusion applies to both one-time payments and payments made over a period of time. However, any portion of the award that is attributable to lost wages or punitive damages would be subject to an income tax.

Any applicable estate and gift tax issues should also be discussed with the clients. Estate tax issues related to special needs trusts are essentially the same that would need to be discussed with clients that do not have a special needs family member. Gift tax implications may exist if the clients intend to fund a trust during their life and such gifts (when added to any other gifts made or deemed made to the beneficiary during the year) exceed the annual gift tax allowance. Also, any gifts made directly to the beneficiary could cause problems with the beneficiary's eligibility for government benefits. Withdrawal (or Crummey withdrawal) rights under a life insurance trust will most likely result in a gift and thus income to the beneficiary for eligibility purposes.[12]

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[11] IRC § 104(a)(2).

[12] 42 U.S.C. § 1382a (a)(2)(D) and (E).