ASSET PRESERVATION AND THE IMPORTANCE OF SPECIAL NEEDS TRUSTS

By Randall K. Craig

Many arrangements and types of ownership of property can be utilized to achieve particular asset preservation goals and objectives. For example, tenants by the entirety ownership of property between a husband and wife will provide protection against claims by some third parties as well as for certain public benefits purposes. In addition, long-term care insurance can provide a mechanism to pay for long-term care, thus freeing up other assets and allowing time to work to the advantage of certain transferors who may have divested themselves of assets or made transfers to trusts which may have given rise to a period of ineligibility for public benefits.

The emphasis of this article will be the realization or preservation of eligibility for public benefits. Of course, asset preservation as an area of concern may include such other objectives as tax avoidance or minimization, avoiding claims of third parties, or preserving or providing for the liquidity needs of a decedent's estate. Most experienced elder law attorneys prefer the phrase "asset preservation" to Medicaid planning or to even the broader concept of public benefits planning, as it connotes a broader perspective than merely obtaining eligibility for public benefits. The author also generally prefers the phrase "lifetime and asset preservation planning" to estate planning, again because of the much broader perspective.

Asset preservation and special needs planning is an extremely important process, since almost everyone wants to have and retain enough resources to provide for themselves and to leave something for their progeny or for posterity. The focus of this article will be on trusts, and particular emphasis will be placed on special needs trusts. In general, a trust of one or another type will be the most efficacious and flexible vehicle for accomplishing the goals and objectives of asset preservation, which often will include providing for the individual's needs, or the needs of a spouse, while maintaining as much control as possible and without tainting the asset protection arrangement being utilized, or providing for the benefit of a child or loved one without causing the beneficiary to lose important public benefits. Trusts in general, and in particular special needs trusts, are very useful devices for addressing these concerns.

Medicaid Transfers In General

The Omnibus Budge Reconciliation Act of 1993 (referred to generally as "OBRA 93") applies to assets disposed of after August 10, 1993, and trusts established after that date. The "look-back" period for identifying uncompensated transfers of assets is 36 months, except in the case of payments from a trust or portions of a trust which are treated as disposed of by the individual and are subject

to a 60-month look-back period. For a Medicaid applicant who applies for Medicaid subsequent to admission to a long-term care facility, the look-back period runs from the date of application. For an applicant who enters an institution while receiving Medicaid, the look-back period is dated back from the date of admission. A significant change was effected by the Deficit Reduction Act of 2005 (generally referred to either as "DRA" or "DFRA").[1] The DRA extends the look-back date to a date that is 60 months in all cases after February 8, 2006, the date of enactment, subject to an extension of the effective date provisions to accomplish certain state law amendments.[2] While a transfer made after the effective date will presumably impact eligibility for up to five years, any previous transfers which occurred prior to the effective date would not be affected by the change in the look-back period. Further, the change to a 60-month look-back period should at least no longer discourage, if not actually encourage, the utilization of trusts in light of pre-DRA five-year look-back period applicable to trust transfers.

There is currently no penalty, speaking generally, for a person at home receiving regular Medicaid except in the case of certain waivered services.[3] The applicable penalty period is determined by dividing the value of the property transferred by a set rate. Currently, the average monthly private pay rate for nursing home facilities in the state-wide geographical area is used in computing transfer penalties. For transfers on or after July 1, 2006, the so-called "divestment penalty divisor" is $3,960. Consequently, a $70,000 lump-sum transfer would give rise to a 17-month penalty.[4]

The DRA abrogates the use of rounding down, so that, in the past, when the quotient determined by dividing the amount transferred by the divestment penalty divisor gave rise to a penalty involving a decimal or a fraction, the penalty could be rounded down to the next lowest number. This is no longer permissible under the DRA.[5] The U.S. Centers for Medicare and Medicaid Services (CMS) has issued to state Medicaid directors two guidance documents on the DRA, including extension of the look-back period and the start date of the penalty period, as well as establishing other guidelines.[6]

SSI Transfer Rules

The Supplemental Security Income ("SSI") program is a federal program administered to provide a minimum level of monthly income.[7] The SSI resource and transfer rules are very similar in structure to the Medicaid resource and transfer of asset rules, except that the "look-back" period is always 36 months in the case of SSI.[8] The "penalty period" for SSI purposes, which is a period of time during which a person cannot receive SSI benefits because of the transfer, and which can never be more than 36 months, is calculated by dividing the amount transferred by the maximum SSI benefit (the federal benefit rate plus the state supplement, if applicable).[9] In 2006, the SSI benefit for an individual in a state such as Indiana which does not provide a state supplement is $603, and for a couple it is

$904. Consequently, if a single SSI beneficiary transfers the sum of $10,000, then the penalty period would be 16 months.[10] As in the case of Medicaid, certain transfers of the home may be exempted, as well as transfers of resources to a spouse.[11]

Other Benefit Programs

There are many benefit programs which are not based on need, such as Social Security Disability and Medicare, as well as numerous benefit programs other than SSI and Medicaid which are based on need, such as the housing choice voucher program (the so-called “Section 8" program) and certain veteran’s benefits programs. While this article will not address programs other than Medicaid and SSI, additional information can be obtained on line concerning the Section 8 and the VA programs.[12]

Using Trusts for Asset Protection

Various standards are used in order to guide the trustee when making distribution of either the income or principal of a trust. It should be remembered that the reference to “income” in the case of a trust will generally mean “income” as determined by the trust document and applicable state law, including, if applicable, the Uniform Principal and Income Act, in which case “income” would generally not include capital gains. The goal for asset preservation purposes is generally to maximize the trustee’s discretion in order to protect the underlying assets. If the trustee has “discretion” to “spray” the income or to make distributions of principal, then the trustee would generally make such distributions in accordance with a designated standard. In general, with less discretion, the opportunities for asset protection are reduced. If an “ascertainable standard” is used, such as the so-called “HEMS criteria” of health, education, maintenance and support, then it may be possible for the beneficiary to serve as the trustee for certain purposes without jeopardizing the trust for inclusion in the beneficiary’s estate for federal estate tax or Indiana inheritance tax purposes. The use of such “ascertainable standards” will not necessarily work for asset preservation purposes, and a standard of “support” will generally make the trust subject to the claims of third parties such as the Medicaid agency and other possible creditors of the beneficiary, particularly if the beneficiary is also the settlor of the trust.

Giving the trustee “absolute” discretion, with no objective standard, will make the trust a fully “discretionary” trust, which can likely be immune from the claims of creditors as a spendthrift trust, and possibly, but not necessarily, protect the trust from claims of Medicaid agencies and other third parties. “Absolute” discretion with instructions not to make distributions that would reduce or replace government benefits is commonly what is referred to as a “special needs trust” (“SNT”).

In Indiana, a third-party created trust in which the settlor has retained no beneficial interest, even if it contains a spendthrift provision, has been held subject to

a third-party claim for medical necessities furnished by the third party when the medical expenses were not paid by the trustee.[13] In *Sisters of Mercy*, there was no express prohibition relating to the trust's payment for medical necessities, and the court held that absent such an express direction to the trustee, both Indiana policy and the decedent's presumed intent were found to support enforcement of payments to the creditor for necessities furnished to the beneficiary.[14]

In general, if the grantor has control of trust assets, those assets will be considered available and vulnerable to creditors. A beneficiary who does not have control may have protection depending on the terms of the trust and applicable state law, and whether or not the beneficiary has the power to compel distributions. A "spendthrift" provision will provide protection, generally, against claims by most third parties, but not necessarily for Medicaid purposes.[15] Trusts must be irrevocable in order to provide asset protection. In general, for Medicaid and SSI purposes, a trust in which the Medicaid applicant or the spouse retains an interest will not be protected and will generally be counted as available. One exception is the "income-only" trust pursuant to which "only income" but not principal is payable to the grantor beneficiary. With an "income-only" trust, the principal may be immunized, subject to the transfer penalty implications. A trust for a surviving spouse intended to meet only special needs and not count as the spouse's assets must be established under a will (i.e., it must be a testamentary trust, and not a living trust), so that the assets will not be counted as available to the surviving spouse for the purpose of Medicaid.[16]

Self-Settled Versus Third-Party Trusts

SNTs, also referred to as supplemental needs trusts or supplemental care trusts, can be divided into two classes: those created and funded by someone other than the person receiving benefits, in which case they are referred to as third-party created trusts; and those funded with the beneficiary's own assets, which are generally referred to as "self-settled" trusts. In most cases, trusts created with personal injury settlements will fall in the latter category. For "self-settled" trusts, both the Medicaid and SSI rules are very strict regarding the trusts that are allowed to be exempt for eligibility purposes. Trusts that do not meet a safe-harbor will be counted as belonging to the applicant/recipient, rendering him or her ineligible for benefits. In general, the "safe-harbors" for such self-settled trusts are found at 42 U.S.C. §1396p(d)(4), and are generally referred to as either "(d)(4)(A) trusts," "(d)(4)(B) trusts," or "(d)(4)(C) trusts." Admittedly, when there are assets available to be protected, there frequently will be certain alternatives to the so-called (d)(4)(A), (d)(4)(B) and (d)(4)(C) special needs trusts. For example, such resources can be used to purchase exempt assets, such as a motor vehicle or a home, to pay off debt, including mortgages and credit card debts, or prepay bills, or the individual may give up needs-based benefits and rely on the individual's resources, income and non-needs based benefits. It is also possible to enter into personal service contracts for a limited term or for life.[17] In most instances, however, a special needs trust or

"SNT" will provide the most flexible mechanism for preserving the available resources and providing for the future needs of the trust beneficiary.

Third-Party Created Trusts

In general, if a trust is absolutely discretionary and not created for a spouse, and if it is established properly, it will have no public benefits consequences. Such a trust can be either an *inter vivos* trust or a testamentary trust. For Medicaid purposes, a special needs trust created for the benefit of a spouse can only be established pursuant to the deceased spouse's last will and testament (i.e., it must be a testamentary special needs trust for the benefit of the surviving spouse). As a basic element of asset preservation planning when the incapacity of one of the spouses is a concern, the bulk of the spousal assets should be transferred to or under the control of the well spouse who should establish a testamentary special needs trust for the benefit of the ill spouse. Then, if the well spouse in fact predeceases the ill spouse, all of the assets can be protected and may provide a supplemental care fund for the surviving ill spouse without having any impact on the surviving spouse's eligibility for Medicaid. In such a case there is no Medicaid look-back period or transfer penalty consequences of such an arrangement and virtually all of the marital assets can be protected while achieving virtually instantaneous Medicaid eligibility for the surviving spouse following the death of the predeceasing spouse. Estate recovery against the estate of a surviving spouse, following the death of a surviving spouse, is an issue that must be considered, however, in the context of Medicaid.[18]

42 U.S.C. §1396p(d)(4)(A) [SSA §1917(d)(4)(A)] Trusts

This so-called (d)(4)(A) disability trust may be established by a parent, grandparent, a legal guardian, or the court, with the assets of a Medicaid or SSI beneficiary who is under 65 years of age. Even though the trust may be established by the parent or other permissible creator, the assets of the beneficiary may be used to fund the trust. This type of trust does not give rise to a Medicaid or SSI transfer penalty, and the assets in the trust are protected as long as they are used to provide for the "supplemental needs" of the beneficiary and not for general support. Assets may be transferred for the beneficiary, such as might be received in the case of an inheritance or a personal injury settlement, so as not to give rise to excess resources or to incur a Medicaid or SSI penalty. Consequently, the beneficiary's eligibility for Medicaid and SSI will not be affected. The income will generally be attributable to the beneficiary for income tax purposes, but as long as it is used to provide for the beneficiary's "special needs" no disqualification for Medicaid or SSI will occur. Upon the death of the beneficiary, however, the remainder must be made available to the State Medicaid agency for reimbursement of medical expenses. This is the so-called "pay back" requirement.

42 U.S.C. §1396p(d)(4)(B) [SSA §1917(d)(4)(B)] Trusts

This is the so-called "Miller" trust or "qualified income trust" which will apply most frequently in states which impose an income limit for Medicaid eligibility purposes. This trust consists solely of pension, social security and other retirement income, plus accumulated income on those trust amounts. As in the case of a (d)(4)(A) trust, a (d)(4)(B) trust must provide that any sums remaining in the trust upon the death of the beneficiary will first be used to repay the State for Medicaid expenditures.

This type of trust will become the assignee of all periodic income of the beneficiary, and the income so assigned does not count toward Medicaid eligibility, but is still treated as income for the purpose of calculating the beneficiary's duty to contribute to the cost of care as required under 42 C.F.R. §435.725(c). The same regulation directs that the cost of care contribution be reduced by a personal needs allowance, payments to the community spouse (to the extent necessary to bring the community spouse's income up to the minimum monthly maintenance needs allowance level), and Medicare Part B premiums, among other items.

Mechanically, a (d)(4)(B) trust should be operated so that each month it receives all of the beneficiary's income, and immediately makes appropriate payments to the nursing home facility or the care provider, the beneficiary (for his or her personal needs amount), and the spouse. Within a few days of the receipt of the monthly income, the trust account may be virtually emptied. There is no requirement that the personal needs be paid or directed from the trust account, nor that any unused personal needs accumulate. Because the trust must provide for the repayment of the State's Medicaid contributions at the beneficiary's death, there is good reason to maintain the trust balance at the lowest possible level.[19]

Although Indiana is not a so-called "income-cap" state, for certain waivered services, such as the development disabilities or DD waiver and the support services or SS waiver, the special income level (the so-called "SIL") test applies. The SIL is equal to the personal needs allowance used for the SS and DD waivers. If the individual fails the SIL test (i.e., the income is more than the SIL), then the individual is ineligible for the waiver. If the individual is married, the spousal impoverishment rules are applicable. Depending on the situation as explained in the ICES Program Policy Manual, regular or spousal post-eligibility budgeting is used, and the amount of the personal needs allowance varies by waiver. For the purpose of post-eligibility budgeting, *see* ICES Program Policy Manual §3301.20.04.[20]

The SIL, or maximum income, for waivered services is $1,809 as of January 1, 2006. This is equal to 300 percent of the maximum benefit payable under the SSI program, and increases annually when SSI increases in January of each year. In the case of an individual with a large monthly income, who may be diverted from a nursing home to the home under the Medicaid home diversion waiver, if the Medicaid recipient's income is greater than the SIL, the individual would be ineligible for Medicaid. In other words, the individual could be eligible for Medicaid in the facility,

utilizing the spousal impoverishment rules, but lose eligibility when he returns home under the diversion waiver because of the excess monthly income. Utilizing a (d)(4)(B) trust can avoid this result.

42 U.S.C. §1396p(d)(4)(C) [SSA §1917(d)(4)(C)] Trusts

This kind of a trust is the so-called "pooled trust" or "non-profit association trust," which is established as a master trust by a charitable organization which is responsible for management of the trust. Examples of a (d)(4)(C) "pooled" trust are the SWIRCA Pooled Trust established by Southwestern Indiana Regional Council on Aging, Inc. and the ARC of Indiana Master Trust.[21] A trust "sub-account" is established for the particular beneficiary under the penumbra of the master trust, which may be established with the beneficiary's assets by the beneficiary himself as well as a parent, grandparent, legal guardian or the court. As in the case of the (d)(4)(A) trust, this type of trust shelters the assets belonging to the person who is disabled, and will not affect the beneficiary's Medicaid or SSI eligibility as long as the trust is used for supplemental needs and not for support. As with the (d)(4)(A) trust, the income may be attributable to the beneficiary for income tax purposes, and there is no transfer penalty, except for transfers of a beneficiary's own assets if the beneficiary is 65 years of age or older. As in the case of the (d)(4)(A) and (d)(4)(B) trust, there is a "pay-back" requirement to the State Medicaid agency for reimbursement of medical expenses. However, there is an exception in the case of a (d)(4)(C) trust to the extent that the remaining assets stay in the trust following the death of a beneficiary. A (d)(4)(C) "pooled trust" sub-account is a very helpful mechanism for a disabled beneficiary when there may not be a family member available to hold or administer assets in conjunction with another arrangement, such as a (d)(4)(A) trust, or when the assets available for protection are so small as to make it difficult to justify utilization of a private trust.

Special SSI Restrictions Applicable to SNTs

In addition to the statutory requirements of 42 U.S.C. §1396p(d)(4), there are special SSI requirements.[22] Some regional offices have published regional instructions relating to what is necessary to have a valid irrevocable trust under state law, which is a requirement for these safe-harbor SNTs. The Program Operations Manual System ("POMS") should be consulted for special SSI requirements.[23] For example, prior to August 15, 2002, some SSA regional counsel took the position that *inter vivos* or *post mortem* payment of taxes, trustee fees, or other administrative expenses violated the Medicaid repayment requirement. The POMS were amended to make it clear that the "sole benefit" requirement is not violated if certain administrative expenses are paid during the life of the disabled beneficiary, and certain others are paid after death but before the repayment of Medicaid.[24] In general, taxes and reasonable fees may be paid. Payment of debts owed to third parties, funeral expenses (the so-called "stinking dead body rule"), and payments to residual beneficiaries are not permitted.[25]

In general, the Social Security Act ("SSA") does not recognize a SNT *per se* for SSI purposes, but instead distinguishes trusts that are available resources to the beneficiary for the purpose of determining eligibility for SSI. The SSA describes a discretionary trust as a trust in which the trustee has full discretion as to the time, purpose and amount of all distributions. If a beneficiary has no control over the distributions, the trust is not an available resource for SSI eligibility. Distributions from a SNT for a beneficiary receiving these benefits, however, may trigger both tax and public benefits consequences depending on how and for what purpose the distributions are made.

The Medicaid rules are somewhat different. Generally, trust income and principal would be considered to be "available" if either the income or the principal can be used for a particular purpose. Much more flexibility is available for a third-party created trust. In the case of a third-party created trust, it is generally safer to avoid criteria such as "support" or "health" and instead to refer to specified "special needs" or "supplemental care" criteria and to include very clear and specific language that the beneficiary's needs-based benefits shall not be affected by trust distributions. Self-settled trusts will generally be considered available for SSI purposes unless created prior to January 1, 2000, in which case such grandfathered trusts, if irrevocable and discretionary, will in most cases not be considered to be available until funds are distributed. The "safe-harbor" SNTs previously referenced as (d)(4)(A), (d)(4)(B) and (d)(4)(C) trusts for disabled persons are exempted for both Medicaid and SSI purposes.

Benefits and Tax Consequences of Distributions

For needs-based benefits such as SSI and Medicaid, in general, "income" will be cash or anything that can be used to provide for food, clothing or shelter. This differs from the income tax consequences of "income," as "taxable income" for trust beneficiaries can either be a direct distribution to a beneficiary or payments made to another person for the benefit of the beneficiary. For example, if the trustee of a SNT pays the telephone bill of the beneficiary out of the trust income, the beneficiary has received a benefit and will be deemed to have received "taxable" income. The beneficiary did not receive "income" for benefits purposes, however, because the beneficiary received neither cash nor food, clothing or shelter.

In designing a SNT, it is very important to be careful regarding the types of income or distributions that will be received by or payable to the SNT. A SNT that is the designated beneficiary of a retirement plan or account will be subject to the trust income rules found at I.R.C. §641 *et seq.* Ordinary income not distributed is taxed at compressed rates in the case of a trust.[26] If a designated beneficiary receives the retirement proceeds directly, as opposed to the proceeds being received by a trust, the tax consequences can be significantly different than if the retirement distribution is left inside the trust. A trust which is not a "grantor trust" is treated as a separate

tax entity and discretionary distributions of income will pass through to the beneficiary to the extent distributed.

After the death of a participant, distributions of qualified dollars are generally taxed as income in respect of a decedent ("IRD"), taxed to the beneficiary when received, with taxation being accelerated if the right to receive the income is transferred to the beneficiary or the beneficiary's estate. IRD distributions from retirement plans are considered wholly or partial distributions of principal for trust accounting purposes, while for income tax purposes, such distributions are considered income. When a trust is the beneficiary of IRD, to avoid problems, the trust should allow the trustee to distribute discretionary amounts of income and principal to avoid "trapping" the income at the trust level and subjecting the distributions to higher tax rates. This would be problematic, however, in the case of a SNT, which must be established for the "sole benefit" of the disabled beneficiary and which may require the accumulation of income to preserve benefits.

If the expected needs of the SNT beneficiary are less than the minimum required distribution amounts from a retirement plan or account, then the SNT may not be the most desirable beneficiary. Distributions to avoid tax at the trust level may eliminate eligibility for SSI and Medicaid, while distributions not made will be taxed at the trust level at compressed rates. In such cases, the retirement plan might better be payable to a beneficiary who is not disabled, and for other assets, such as insurance, to be paid or distributed to the SNT.[27] If there are other beneficiaries in addition to the disabled beneficiary, which is possible in the case of a third-party created SNT, but is not possible in the case of a "safe harbor" (d)(4)(A), (d)(4)(B) or (d)(4)(C) SNT, then the IRD distributions may be distributed to the non-disabled beneficiary as a means of avoiding tax without affecting the disabled beneficiary's eligibility for SSI and Medicaid. Life insurance is an excellent funding vehicle for a special needs trust because of the absence of federal and state income tax and Indiana inheritance tax consequences.

SSI Consequences of Distributions for Benefit Purposes

For SSI purposes, "income" is anything an individual receives in cash or in kind that can be used to meet the individual's needs for food, clothing and shelter. Receipt of anything not specifically exempted which can be applied, either directly or indirectly, by sale or conversion, to meet basic needs of food, clothing and shelter, will be treated as income. Since there is no specific exemption for a jet ski, receipt of a jet ski as an inheritance would result in an assumption that it could be sold or converted and the value would count as income in the month that it is received.

For every dollar more than (i) $20 per month of "unearned income" paid to an SSI recipient, and (ii) one-half of earned income above $65 per month, his or her benefits will be reduced dollar for dollar. Cash paid directly from the trust to the

individual will always count as income and will reduced the SNT beneficiary's benefits dollar for dollar.

A trustee's payment to a third party not providing a disabled beneficiary with food, clothing or shelter does not cause disqualification or a diminution of benefits. Payments of an individual's bills (including supplementary or other medical insurance premiums) by the trust directly is not income, unless the payment results in the beneficiary receiving an asset as a result of the payment that can be used for food, clothing and shelter. A payment for food, clothing or shelter is countable income called "In-Kind Support and Maintenance" ("ISM"). Receipt, or the right to receive, ISM (i.e., actual food, clothing and shelter), will result in a reduction of SSI benefits on a dollar-for-dollar basis, up to a presumed maximum value ("PMV"). The PMV is the limit on the amount of ISM that can be charged. Any food, clothing or shelter received is presumed to have a maximum value. The amount of the PMV is equal to one-third of the federal benefit rate in effect for the month in which ISM is received for an individual or an eligible couple, plus $20, unless the $20 disregard has already been applied to an unearned income payment. The PMV rate for 2006 is $221 (less $20, if applicable, for a reduction to $201, if the $20 disregard has already been applied). The PMV rule gives the trustee discretion to make distributions for shelter costs with the result that paying the beneficiary's rent will cause a reduction of the beneficiary's SSI by a maximum of $201 per month.

If the actual value of the ISM is less than the PMV, only the actual value is counted as ISM. For example, if a third party pays residential utilities of $100, then only $100 is counted as ISM. The $100 amount is divided equally among all the household members. If the household has four members, only $25 is ISM is counted for the SSI eligible individual.

Information concerning the ownership of a home by a trust can be found in the POMS.[28] If a trust is not a resource for SSI purposes, and purchases and holds a residence as a home for the beneficiary, the residence is not a resource to the beneficiary, nor would it be a resource if the beneficiary moves from the home. Since the trust holds legal title, the beneficiary would be considered to have "equitable" ownership under a trust, and would be considered to be living in his or her own home. A beneficiary does not receive ISM in the form of rent-free shelter while living at a home in which he or she has an ownership interest. Payment of rent by the beneficiary will not affect his or her SSI payments.

Since the purchase of a home by the trust establishes equitable ownership for the beneficiary, the purchase results in receipt of shelter in the month of purchase that is income in the form of ISM which will be valued at no more than the PMV. Even though the beneficiary has an ownership interest, and if living in the home, does not receive ISM in the form of rent-free shelter, the purchase of the home or payment of a monthly mortgage payment by the trust is a disbursement

from the trust to a third party that results in the receipt of ISM in the form of shelter in the month of payment.

If the trust, which is not a resource, purchases the home outright, and the individual lives in the home in the month purchased, the home would be income in the form of ISM and would reduce the individual's payment by no more than the PMV in the month of the purchase only, regardless of the value of the home. If the trust, which is not a resource, purchases the home with a mortgage and the individual is living in the home in the month purchased, the home would be ISM in the month of purchase. Each subsequent monthly mortgage payment would result in the receipt of income in the form of ISM to the beneficiary living in the house, each valued at no more than the PMV.

If the trust pays for other shelter or household operating costs, such payments would be treated as ISM in the amount of the payment. If the trust pays for improvements or renovations to the home, such as renovations to make it handicap accessible or installation of a wheelchair ramp, or other assistance devices, the individual does not receive income. Disbursements from the trust for improvements, unlike household operating expenses, do not result in ISM.

Medicaid Income Differences

Indiana generally follows the federal SSI definitions with certain deductions and exclusions. For additional information, *see* 405 IAC 2-3-3 *et seq*.[29]

Special Needs Trust Drafting and Administration Issues

Many trustees are clueless about the proper management of SNTs. Consequently, including special instructions may help, and including provisions in the trust agreement that direct the SSA staff to the eight-step action chart in the POMS can be helpful in assuring a favorable review and approval of the SNT by SSA.[30]

It is generally a good idea to give the trustee specific instructions to consider only the best interests and needs of the disabled person, and to advise the trustee that its sole responsibility is to do what is in the best interest of the SNT beneficiary. The trustee should be encouraged in the trust document to employ social workers, attorneys and other experts to aid the trustee in the proper management of the trust. The trustee should be alerted to the need to purchase pre-need funeral services and burial plots, possibly through actions of a guardian or attorney-in-fact and using other available assets, and to avoid the "stinking dead body rule" for SSI purposes, if applicable. It is a good idea to include an "escape hatch" to amend the trust to conform to its purposes and changes in the law. Given the lengthy appeals process for SSI purposes, it may make sense to amend the trust to conform to SSA's demands rather than to appeal, or to amend and file a new application.

The trustee should be advised of the SSI recipient's duties to report any changes in income, resources and living arrangements or other conditions.[31] The trustee should be aware of the following issues concerning the beneficiary and the beneficiary's family: How sophisticated is the beneficiary financially, and how much assistance, financial and otherwise, is the beneficiary likely to need? How sick is the beneficiary and what kinds of medical assistance, care, and attention is the beneficiary likely to need? Are there other resources available to support the beneficiary and the beneficiary's family? All distributions should be made with an awareness of the income and resource implications of doing so and the trustee must be able and willing to follow the sole benefit requirements application to SNTs.

The family may consider giving special instructions to the trustee for guidance in the administration of the trust for the principal beneficiary. The family should give the trustee guidance concerning the extent to which the beneficiary is able to handle his or her own finances, sign checks, or control certain funds. The trustee should also be aware of the kind of living conditions the beneficiary is accustomed to (e.g., Does he expect his own bedroom or a particular kind of bed or mattress?), and the kinds of appliances and entertainment mechanisms the beneficiary expects or desires. It is also important to be aware of the specific medical issues that must be addressed, such as the medications that he takes and the identity his medical providers, and knowing his employment and work capabilities. By attending to these issues, not only can public benefits eligibility issues be avoided, but the principal purpose of the SNT, which is to make the life of the beneficiary better, can be more realistically achieved and the trust more effectively administered.

Tax Issues in the Administration of SNTs

Whether the SNT is set up by a third party or whether it is self-settled, it will frequently be advisable to obtain a separate taxpayer identification number for the trust and for the trustee to file fiduciary income tax returns. SNTs are usually either complex trusts or grantor trusts for income tax purposes. If it is non-grantor trust, the SNT will typically not be a "simple" trust because it is generally not advisable to require the distribution of all income to or for the benefit of a beneficiary each year. The trustee will generally have discretion whether or not to distribute the income. A third-party SNT is usually treated as a "complex trust" for income tax purposes, while a self-settled SNT is generally a grantor trust for income tax purposes. It should be noted that a non-grantor trust which is not subject to the requirements of 42 U.S.C. §1396p(b)(4)(A) or (C) may also provide for other beneficiaries as permissible distributees of the income.[32]

When creating self-settled trusts, practitioners often include provisions to have the trust treated as a grantor trust. Various provisions of the Internal Revenue Code govern the treatment of a trust as a grantor trust for federal income tax purposes.[33] However, the income tax grantor treatment may be different than the

treatment of the trust for federal estate tax purposes. There mere fact that the grantor is subject to income tax on the income does not necessarily require inclusion in his or her estate for estate tax purposes. There is no absolute correlation between the income tax and estate tax aspects of the grantor trust rules.[34]

If a parent establishes a third party special needs trust and is designated as the trustee, and retains the power to accumulate income for the child's benefit or distributions to be made at the parents' discretion, which is not covered by an ascertainable standard, the trust assets would be taxed in the parents' estate for federal estate tax purposes. A reserved power to substitute other property of equal value for property already held in the trust would make the trust a grantor trust for income tax purposes, but since it is not a power to alter, amend or revoke, it does not make the trust includable for estate tax purposes. Although certain types of economic control over the trust may make the trust income taxable to the grantor, the trust itself is not, on that ground alone, includable in the grantor's estate for estate tax purposes.

Consider Other Flexible Trust Planning Provisions

It is frequently advisable to add a "trust protector" provision, which generally involves designating a person with authority to remove and replace the trustee if the trustee is not adequately discharging the fiduciary's duties or in the event of other stated circumstances. It will also generally be advisable to include a spendthrift provision, i.e., a provision protecting the trust assets from the claims of the beneficiary's creditors.[35] Provisions should also included authorizing trustee compensation and payment of fees, taxes and administrative expenses, and amendment of the trust by the trustee or a court is necessary to comply with applicable federal and state laws, regulations and policies concerning SNTs.

It will generally not be advisable to include discretionary support provisions. Some practitioners use fully discretionary language with the precatory special needs language, while others use a fully discretionary trust but prohibit distributions for food, clothing and shelter. In light of the uncertainty of the future needs of the beneficiary, such a provision is considered by some to be overly restrictive. Some practitioners use a fully discretionary trust that specifically authorizes the trustee to provide in-kind support if the trustee deems that the beneficiary's needs will be better met with a distribution in spite of the partial reduction in SSI benefits or Medicaid due to the PMV rules.

SNTs and all trusts must be drafted with an awareness of the possibility of estate recovery against the trust assets.[36] Consideration should also be given to the fraudulent transfer rules and obligations that third parties may have to support a beneficiary.[37]

CONCLUSION

It is hoped that the foregoing comments will provide helpful guidance to attorneys as they draft trusts which are designed to achieve asset protection, as well as assist other practitioners that may be involved in the design or planning of such trusts or in their administration. While it is impossible to address all legal, tax, and financial issues relating to trusts, or even specifically special needs trusts, it has been the goal of this article to provide a comprehensive analysis of most of the issues that have a significant impact on trusts designed for asset protection and to point out that, when the goal is the preservation of assets, a trust will generally offer the most effective mechanism for accomplishing the numerous goals and objectives of asset preservation planning. Special needs trusts in particular will offer unique opportunities to preserve the assets of a recipient of public benefits and to make the life of special needs beneficiaries better than would be possible in the absence of such arrangements.