
SUNCOAST ESTATE PLANNING COUNCIL

October 21, 2010

TAXES and SPECIAL NEEDS TRUSTS

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A. The Basics of Special Needs Trusts

I. Medicaid: OBRA 1993-- OBRA 1993 Exempt Trusts

In spite of Congressional efforts to place greater controls on Trusts and expand Medicaid's ability to access Trust funds, OBRA 1993 did establish a class of Trusts that are exempt from the expanded Medicaid Qualifying Trust rules, and from the 60 month look-back period. For the first time in Medicaid history, Congress authorized a class of Trusts in which neither their creation nor their funding would affect the Medicaid eligibility of the creator or the beneficiary.

There are three (3) types of Trusts that are exempt under OBRA 1993:

A. Special Needs Trust

1) The Special Needs Trust, also referred to as a "Supplemental Needs Trust," a "Disability Trust," or a "Payback Trust," is available only to individuals who are disabled and under the age of 65 years. The Trust must be funded with the assets of the individual who is disabled and must be created for his or her benefit by a parent, a grandparent, or a legal guardian of the individual or a court. The funding will not affect the Medicaid eligibility of the individual.

There is a statutory requirement that the disabled beneficiary be under the age of sixty-five (65) upon the creation of the Trust. If a Special Needs Trust is created for an individual who is under the age of 65, that Trust will remain exempt if the individual lives beyond the age of 65. However, any assets added to the Trust after the individual reaches age 65 will be subject to the Medicaid transfer penalty rules.

Although the Special Needs Trust authorized by OBRA 1993 is exempt for Medicaid eligibility purposes, it is subject to certain statutory restrictions. In order to meet statutory requirements for exemption, the Special Needs Trust must contain a pay back provision. Upon the death of the individual, any balance left in the Trust must be paid back to the Department of Health in an amount not to exceed the Medicaid benefits paid on behalf of the individual.

The language of the federal statute regarding the pay back provides that the "... state will receive all amounts remaining in the trust upon the death of such individual up to an amount equal to the total Medicaid assistance paid on behalf of the individual under a state plan under this subchapter." (42 U.S.C.A. §1396p(d)(4)(B)(ii)). This language raises an issue: Whether Medicaid is entitled to recover any assistance paid on behalf of the individual prior to the creation of the Trust. Since, upon the death of the disabled individual the balance of the Trust funds will not be part of that individual's probate estate; it would not be subject to a Medicaid estate claim. Thus, if the individual received Medicaid assistance prior

to the creation of the Trust, and if the Trust was left with considerable assets after the individual's death, the issue of whether Medicaid benefits granted prior to the creation of the Trust are recoverable is an important one.

There is no longer any question in New York State as to whether the payback provision requires payback of all Medicaid previously paid, including payments prior to the creation of the Trust. The New York Court of Appeals, reversing an Appellate Division decision, ruled that all Medicaid payments including pre-trust payments are subject to the payback provision.¹

If the Special Needs Trust is funded with the proceeds of a negligence or medical malpractice suit brought on behalf of the beneficiary of the Special Needs Trust, it is possible that there would be a Medicaid lien against the proceeds for the repayment of Medicaid benefits paid to treat the injury or condition caused by the negligence or medical malpractice. It has been determined that such liens must be satisfied prior to the funding of a Special Needs Trust.

B. Qualified Income Trusts

2) The Qualified Income Trust, the second exempt Trust authorized by OBRA 1993 is a Trust funded solely with an individual's income. It was intended for use only in an income cap state. An income cap state is one in which the state establishes a maximum income level for Medicaid recipients. If an individual has income, even one dollar, in excess of the maximum income level or income cap, such individual is not eligible for Medicaid, even if the medical expenses are greater than the amount of income over the income cap. For example, an individual in an income cap state could be ineligible for Medicaid because of a \$10.00 per month income excess, and have no Medicaid coverage for a \$3,000 per month nursing home bill.

OBRA 1993 helped alleviate this situation by authorizing a Qualified Income Trust to accept an individual's monthly income. The Trust would then authorize payment to the individual of a monthly amount that is less than the income cap of the state. The Trust would hold all of the excess income, and the individual would be Medicaid eligible. This type of Trust has no age or disability requirements. It does, however, have the same pay back requirements as the Special Needs Trust. All Trust funds remaining upon the death of the individual are to be paid back to the state up to the total amount of Medicaid benefits paid on behalf of the individual. Being an income trust with monthly disbursements, there is not likely to be very much in the trust at the time of the death of the beneficiary.

New York State is an income spend-down rather than an income cap state.

¹ In re Abraham XX., 11 N.Y.3d 429, 871 N.Y.S.2d 599, 900 N.E.2d 136 (2008).

In New York State, an individual with income in excess of the Medicaid income limit is eligible if his or her medical expenses exceed the excess income. Recently, elder law attorneys have successfully used qualified income trusts in New York State to shelter excess income, preventing its payment for medical expenses.

C. Pooled Trusts

3) The third exempt Trust established by OBRA 1993 is the "pooled" Trust, which is available to residents of every state, including New York. In a "Pooled Trust," the assets of many individuals who are disabled are held in a single Trust with a separate account for each individual.

Like the Special Needs Trust, this Trust is limited to individuals who are disabled, and under the age of 65. For a pooled Trust to be exempt, the law² requires that it be established and managed by a nonprofit association. A separate account for each disabled individual must be maintained within the Trust. These Trusts may be funded by the disabled individual, or his or her parents, grandparents, legal guardian or by a court. Pooled Trusts must have language similar to the Special Needs Trust, so that payments from the Trust will not replace or reduce Medicaid benefits.

As with the other exempt trusts, any contributions by an individual over the age of 65 are considered transfers subject to a Medicaid transfer penalty for nursing home care. This position was materially altered on July 24, 2008 by the issuance of GIS 08 MA/20.

This GIS reiterates that any additions to a pooled trust after an individual becomes 65 years old are subject to the Medicaid transfer penalty rules.

This GIS then proceeds to explain how income additions to a pooled trust by an over 65 Medicaid Applicant/Recipient (A/R) can be treated as compensated transfers, not subject to a Medicaid transfer penalty.

To the extent that the deposit is used by the pooled trust to pay the monthly expenses of the A/R, they are considered as compensated additions not subject to Medicaid transfer penalties. If the pooled trust pays for items such as rent and/or utilities, then these payments reduce or eliminate the Medicaid transfer penalty.

² Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, August 10, 1993, 107 Stat. 312.

Planning for individuals over the age of 65 who have income being deposited into a pooled trust should consider using all the income for said individual's expenses each month, to maximize the monthly income under this GIS.

Like the two exempt Trusts discussed above, the Pooled Trust also requires a pay back provision. Upon the death of the beneficiary of the Pooled Trust, the balance in his or her account, up to the amount of Medicaid paid on his or her behalf, must be paid back to New York State or its designated Department of Social Services. However, unlike the other two exempt Trusts, the pay back provision can be avoided with a Pooled Trust. If the individual elects to leave the remaining funds in the Trust after his or her death, the pay back requirement will not apply. There is no explanation in the statute as to how the remaining funds of a deceased disabled individual will be handled. Since each individual must have a separate account, it is unexplained in the law where the funds of a deceased individual would pass. Will the funds be divided into the remaining accounts, which would make it subject to a possible future pay back, or will a separate general account be established for the benefit of all Trust beneficiaries? It is likely that a general account for the benefit of all would be preferable to dividing the remaining balance among all the surviving beneficiaries.

The circumstances of each case should determine which of the exempt Trusts discussed in this section is most advantageous.

II. Should an Exempt Trust be Used.

Assuming the individual who is disabled has mental capacity, a decision must be made as to whether it is more advantageous to implement Medicaid planning by asset transfers or by placing his or her assets into an exempt Special Needs Trust or Pooled Trust.

Consideration will have to be given to the possible transfer penalty period, if an exempt Trust is not established, and whether the individual is better off with transfers either outright or to an Irrevocable Income Only Trust as compared to funding a Special Needs or Pooled Trust. If the individual does not require immediate Medicaid benefits, then he or she may be willing to forgo Medicaid during the shorter of the look-back period and the transfer penalty period. In such a plan, the transferred assets will not be subject to recovery by Medicaid.³

The age of the individual must also be considered. If the disabled individual is young, counsel must consider that Medicaid benefits paid when the individual was under the age of 55 are not recoverable and that a Medicaid estate claim can only go back ten

³ Health Care Financing Administration, State Medicaid Manual Transmittal No. 64.

(10) years. In some cases, divesting assets which can create a Medicaid transfer penalty period may be more advantageous than funding an exempt Trust coupled with a pay back requirement or retention by a non-profit organization. It will be critical to determine whether the disabled individual receives community based home care or nursing home care under Medicaid, since there are no transfer penalties for community based home care under Medicaid.

Which approach is taken will depend only partially on the financial consequences of either using or not using an exempt Trust. The elder law attorney should be sensitive to the needs and desires of his or her clients when recommending alternative plans regarding the funds of a disabled individual.

A. Sole Benefit Trusts

An individual can make an exempt transfer to a trust created for the sole benefit of a spouse, a blind or disabled child of any age or to any disabled individual who is under the age of 65.⁴

The New York State position as stated in ADM 96-8 explains sole benefit trust only in the context of the spousal transfers⁵

There are significant differences between the federal and the state directives, in spite of the fact that they both refer to sole benefit trusts.⁶ The Federal document authorizes sole use and benefit trusts for a:

1. spouse;
2. blind or disabled child of any age;
3. a disabled individual who is under the age of 65. There is no requirement that the disabled individual under 65 be related to the grantor/settlor of the trust.

New York State Administrative Directive, referred to above relates only to a spouse or to another for the sole benefit of the spouse,

⁴ Health Care Financing Administration, State Medicaid Manual Transmittal No. 64 (November, 1994), HCFA Pub. 45-3.

⁵ N.Y.S. Department of Social Services Administrative Directive Transmittal, 96 ADM-8.

⁶ Health Care Financing Administration, State Medicaid Manual Transmittal No. 64 (November, 1994), HCFA Pub. 45-3.

This distinction is eliminated by New York State regulations,⁷ which includes the same class of individuals as the Federal document.

There is another major difference between the Federal and the State requirements for sole use and benefit trusts.

The HCFA transmittal requires that for a trust to be considered a sole use as a benefit trust, the trust must provide for spending that is actuarially sound, based on the life expectancy of the beneficiary. If the trust fails to meet this standard, there is a Medicaid transfer penalty.

As a practical matter, the effect of this provision is that the entire corpus of the trust must be paid for the sole benefit of the beneficiary during his/her actuarial lifetime.

The New York State position as evidenced by both the Administrative Directive⁸ and the regulations makes no direct reference to “actuarial soundness” but does provide that:

the social services district must conclude, based on the age of the individual's spouse, the amount of assets transferred, and the rate and amount of expenditures from the transferred assets for the benefit of the individual's spouse, that the transferred assets are likely to be totally expended with the spouse's lifetime.

The New York State Administrative Directive also requires that the trust benefit only the beneficiary and that upon termination the trust balance must be paid to the beneficiary's estate.

This creates the possibility of a Medicaid estate claim, provided Medicaid was paid when the beneficiary was over the age of fifty-five (55). The same requirement is found in the regulations.⁹

There is no explanation as to why the estate requirement is found in the Administrative Directive, which refers only to spouses, and in the portion of the

⁷ 18 NYCRR §360-4.4(c)(2)(iii)(C).

⁸ N.Y.S. Department of Social Services Administrative Directive Transmittal, 96 ADM-8.

⁹ 18 NYCRR §360-4.4(C)(2)(iii)(d)(V).

New York State regulations which is designated as “Transfers for the Sole benefit of a Spouse”.¹⁰

Why New York State authorizes sole benefit trusts for a spouse; a blind or disabled child; or a disabled person under the age of 65, but sets forth the estate requirement only in reference to spouses remains a puzzle.

It should be noted that although a trust for a disabled individual under the age of sixty-five (65) can continue in effect beyond the age of sixty-five, any funding or additional funding of the trust beyond the sixty-fifth birthday of the disabled individual will be considered a transfer subject to a Medicaid transfer penalty period.

It is recommended that when preparing a sole benefit trust a disabled individual under the age of sixty-five (65) in New York State, that any remaining assets be left to the estate of the beneficiary, this approach has been accepted by the local Medicaid agencies. It is the authors' belief that this approach will have the advantage of avoiding an estate recovery if all of the Medicaid was granted when the disabled individual was under the age of fifty-five (55).

The Federal guidelines specifically authorize the payment of trust funds for trustee compensation and expenses. New York regulations and directive make no reference to these expenses. There is general acceptance in New York that the payment of trustee commissions and expenses does not interfere with the sole benefit concept.

III. Special Needs Trust

OBRA 1993 authorizes the funding of a Trust for the benefit of an individual who is disabled under the age of 65 using such individual's own assets (referred to as a "Special Needs Trust," "Supplemental Needs Trust," "Disability Trust," "(d)(4)(a) Trust," or a "Payback Trust"). In order to qualify as an exempt Trust, the document must provide for a payback to Medicaid following the death of the individual who was disabled, from any balance remaining in the Trust. The elder law attorney drafting a Trust pursuant to the statutory exemption of OBRA 1993 must use great care to assure that the payments from the Trust to the individual do not affect such individual's Medicaid eligibility. Payments from the Trust to the individual receive no statutory protection, and must therefore, be designed so as not to duplicate or replace any Medicaid funding. Any duplication or replacement of Medicaid funding would result in the Trust having to pay for expenses that would otherwise be covered by Medicaid. Thus, if a Special Needs Trust authorized the trustee to pay the beneficiary's medical expenses with no qualifying

¹⁰ N.Y.S. Department of Social Services Administrative Directive Transmittal, 96 ADM-8.

language, Trust funds would have to be exhausted before Medicaid would pay any medical expenses.

Special Needs Trusts are intended to supplement rather than duplicate or replace Medicaid benefits. To accomplish this and achieve the benefits of a Special Needs Trust, the trustee's authority must be carefully defined and limited. There has to be a specific limitation to prohibit paying for any expense that would otherwise be paid for by Medicaid or any other means tested entitlement program. Statutory guidance for the language of a Special Needs Trust or Supplemental Needs Trust can be found in New York law.¹¹ It is recommended that the statute be cited in the Trust and that the statutory language be used where appropriate.

Care must also be taken to prevent direct payments to the individual, because direct unrestricted payments are income to the individual which would affect his or her Medicaid eligibility.¹² Provision can be made for the trustee to spend Trust funds on specific items that would not be covered by Medicaid. For example, the trustee could be authorized to purchase a television set for the individual. Since a television set is not a medical item provided by Medicaid, such authorization or purchase would not affect the individual's Medicaid eligibility. The type and number of items and services that can be authorized by a Special Needs Trust are limited only by the experience of the elder law attorney cognizant of the need to avoid any replacement or duplication of items or services available from Medicaid and of the needs of the beneficiary.

In *Matter of La Barbera (Donovan)*,¹³ the Court did not authorize a Special Needs Trust because the record did not establish that the current expenses exceeded the income of the individual.

In *Matter of Sutton*, the Court ordered the establishment of a Special Needs Trust for an infant Medicaid recipient as requested by the guardian appointed under S.C.P.A. Article 17A. In this case, the infant, who suffered from multiple physical disabilities but had no mental impairments, was entitled to an inheritance from his mother's estate.¹⁴

Special Needs Trust and Supplemental Security Income (SSI). Special needs trusts are a valuable planning tool for SSI. In New York State, SSI eligibility creates automatic Medicaid eligibility, the special needs trust for an SSI individual must protect not only SSI eligibility, but Medicaid eligibility as well.

¹¹ EPTL §7-1.12.

¹² EPTL §7-1.12.

¹³ *Matter of La Barbera (Donovan)*, N.Y.L.J. 4/26/96, p.36, col.6 (Sup.Ct., Suffolk County).

¹⁴ *Matter of Sutton*, 167 Misc. 2d 956, 641 N.Y.S.2d 515 (Sur. Ct. 1996).

Because SSI is a cash maintenance program for living expenses, and Medicaid pays various medical expenses, trust language must not allow duplication of living expenses as well as medical expenses. To properly draft a trust, the elder law attorney must be familiar with the benefits covered and provided by both SSI and Medicaid. Thus, if the trust fully protected assets regarding medical expenses but allowed the trustee to pay for or provide housing or pay utility bills, such powers would affect the beneficiary's SSI eligibility.

A trustee can be authorized to provide many items that would enhance the life of the person with special needs while protecting SSI and Medicaid eligibility. The trust can provide recreational opportunities, trips to see family and friends, and even the purchase of a specially equipped van to permit travel. Entertainment devices such as television sets, radios, computers and various electronic devices can be purchased by the trustee for the beneficiary. The trust can be tailored to meet the specific needs of the beneficiary without interfering with SSI or Medicaid eligibility.

A special needs trust should be designed to meet the special needs of the beneficiary. Doing so will result in a document that enhances the life of the beneficiary while protecting SSI and Medicaid eligibility. Knowing your special needs client will enable you to design a document that will truly benefit the client.

Disposition of trust assets upon the death of the disabled beneficiary is also an issue for SSI. Trust provisions that provide for the payment of funeral expenses prior to the payback to Medicaid will not be approved by SSI. For SSI purposes, the trust should provide for the Medicaid payback first, and then provide for funeral, estate, legal and accounting expenses from the remaining balance, if any.

Social Security Administration has also changed the payback language that it will accept for SSI purposes. The payback must not be state specific. SSI requires that "the State" will receive ..., without having a specific state (POMS §SI 01120.203).

IV. Special Needs Trust-- Funding a Special Needs Trust

Frequently the need for a Special Needs Trust arises as a result of a recovery in a medical malpractice or negligence action. The services of elder law attorneys are often sought by medical malpractice and negligence attorneys when Medicaid may be involved. A thorough knowledge of Special Needs Trusts is essential to protect the damages recovered.

Funding a Special Needs Trust with the proceeds of a medical malpractice or negligence action against which a Medicaid lien had been placed was usually a problem, depending on the amount of the lien as compared to the amount of the settlement. There were times when Medicaid would voluntarily reduce or waive its lien to permit funding the Trust, and times when it would refuse.

In a recent case, an attempt was made to fund a special needs trust with the monthly Social Security Disability payments being received by the disabled person in an attempt to reduce the income spend down for Medicaid community home care. The Surrogate's Court ruled that the proposed "hoarding" of entitlement funds is contrary to the purpose of the entitlement, and therefore violates public policy.¹⁵ The court on re-argument reversed itself and permitted the Social Security Disability payments to be paid into the trust.

Later, the same court was confronted with a similar case, this time involving SSI payments.¹⁶ In this case, the court held that SSI payments which have specific definitions as to what the benefits are for, cannot be diverted into a special needs trust.

Litigation arose as to the right of Medicaid to enforce a lien against proceeds that would otherwise go into an exempt Special Needs Trust. Both the Supreme Court and the Appellate Division Second Department ruled that Medicaid could not enforce its lien, except from any remaining assets of the Special Needs Trust after the death of the disabled individual.¹⁷

On appeal¹⁸ the Court of Appeals reversed the Appellate Division, holding that Medicaid was a preferred creditor entitled to recovery from the proceeds prior to funding the Special Needs Trust.

There is no longer any legal issue in New York State regarding the ability of Medicaid to recover its lien from proceeds that would otherwise go into a Special Needs Trust. Given its legal ability to recover, it is up to the elder law attorney to negotiate a

¹⁵ In re Lynch, 703 N.Y.S.2d 653 (Sur. Ct. 1999), withdrawn at request of court from Official Publication.

¹⁶ In re Ullman, 184 Misc. 2d 7, 707 N.Y.S.2d 603 (Sur. Ct. 2000).

¹⁷ Matter of Gibson, 162 Misc. 2d 530, 616 N.Y.S.2d 171 (Sup 1994), amended on reargument, 162 Misc. 2d 587, 620 N.Y.S.2d 729 (Sup 1994), order aff'd, 226 A.D.2d 351, 640 N.Y.S.2d 768 (2d Dep't 1996), rev'd, 90 N.Y.2d 296, 660 N.Y.S.2d 679, 683 N.E.2d 301, 53 Soc. Sec. Rep. Serv. 1010 (1997); Cricchio v. Pennisi, 220 A.D.2d 100, 640 N.Y.S.2d 573 (2d Dep't 1996), order rev'd, 90 N.Y.2d 296, 660 N.Y.S.2d 679, 683 N.E.2d 301, 53 Soc. Sec. Rep. Serv. 1010 (1997); *see also*, Merer v. Romoff, N.Y.L.J. 1/23/97, p.28, col.4 (Sup.Ct., New York County).

¹⁸ Cricchio v. Pennisi, 90 N.Y.2d 296, 660 N.Y.S.2d 679, 683 N.E.2d 301, 53 Soc. Sec. Rep. Serv. 1010 (1997), *see also* Calvanese v. Calvanese, 250 A.D.2d 564, 672 N.Y.S.2d 410 (2d Dep't 1998), aff'd, 93 N.Y.2d 111, 688 N.Y.S.2d 479, 710 N.E.2d 1079 (1999) and Matter of Link, N.Y.L.J. 1/6/98 24 (col.1) (Sup.Ct., Suffolk County, 1998).

reduction or waiver of the lien based on the circumstances of the case. It will be more difficult to negotiate if a large sum of money will be left for the Trust after payment of the lien.

The elder law attorney should make every effort to avoid paying a Medicaid lien which will reduce the amount available to be placed in the Trust. Because there is no certainty as to the amount that will be left in the Special Needs Trust following the individual's death, funds that would otherwise have been paid back to Medicaid may be used for the benefit of the individual during his or her lifetime.

If a Medicaid lien has been filed against the proceeds of an action which proceeds are intended for a special needs trust, having the lien waived or reduced will be most difficult. Since there is a legal basis for collecting the lien prior to funding the trust, only special circumstances of the individual case can be used in the effort to waive or reduce the lien.

Before agreeing to pay any outstanding Medicaid lien prior to funding a special needs trust, it is important to understand the limitations that the U.S. Supreme Court has placed on Medicaid recoveries. Medicaid cannot recover any portion of the settlement that is allocated to pain and suffering or for loss of income. Only the portion of the recovery allocated for medical expenses can be claimed by Medicaid.¹⁹

Whenever possible an attempt should be made to have the court, or the parties to a settlement allocate an amount for medical expenses. Simply allocating a majority of the funds to pain and suffering rather than medical expenses will likely not be successful. An accurate allocation, considering liability, medical expenses and the pain and suffering is most likely to result in a reduction of the Medicaid lien and an increase in the funds available for the trust.

Frequently, a court is involved with the proceeds of a medical malpractice or negligence action on behalf of a disabled person. The services of an elder law attorney are necessary if the proceeds are to be placed into a Special Needs Trust. The elder law attorney should draft the Trust and it should be presented to the court to be used as the vehicle into which the funds will be placed. Not only should the language of the Trust be carefully drafted to prevent any loss or diminution of Medicaid benefits, but also the timing of the funding of the Trust must be carefully planned.

The proceeds of a personal injury or medical malpractice lawsuit will not be counted by Medicaid from the date of receipt or entitlement until the first day of the

¹⁹ Arkansas Dept. of Health and Human Services v. Ahlborn, 547 U.S. 268, 126 S. Ct. 1752, 164 L. Ed. 2d 459 (2006).

second month following the receipt or entitlement, provided the individual intends to place the proceeds into a Special Needs Trust.²⁰

In addition, such assets will be disregarded from the date a proceeding to place the assets into the Special Needs Trust is commenced, until the resolution of such proceeding.²¹ As a result, some alternate source of payment of the individual's medical expenses will have to be found for at least one month, or longer if the Trust is not funded during the same calendar month that the proceeds are made available.

A better alternative is to have the Special Needs Trust prepared and executed prior to the payment of the proceeds and have the proceeds paid directly into the Trust, without being made available to the individual. This will help assure a continuity of Medicaid coverage, without the necessity of privately funding medical expenses for one month or longer.

V. Pooled Trusts

The elder law attorney should explore the Pooled Trust as an alternative to a Special Needs Trust when the individual with disabilities who is under age 65 is in need of long term care.

The Pooled Trust can avoid a payback for Medicaid services provided. The Pooled Trust may be the preference of a family that desires to have any remaining funds benefit the other beneficiaries of the nonprofit organization rather than having the Trust assets paid to the government in satisfaction of the cost of services provided under the Medicaid program.

A drawback (or advantage?) of the Pooled Trust is that the individual's family has no control over the administration or expenditures of the Trust. All such decisions would be made by the trustees of the nonprofit organization. If control of the Trust assets is an important factor for a family, and the disabled individual is under the age of 65, the establishment of an individual Special Needs Trust may be preferable. If upon the creation of an Exempt Trust there is no family member or other appropriate party to administer the Trust on behalf of the individual who is disabled, a Pooled Trust may be preferred. This may also be the choice for the individual who is disabled and for the children of aged or infirmed parents who are concerned about the long-term administration of a Special Needs Trust.

²⁰ N.Y.S. Department of Social Services Administrative Directive: 96 ADM-8.

²¹ N.Y.S. Department of Social Services Administrative Directive: 96 ADM-8.

Although Pooled Trusts are available for disabled persons over the age of sixty-five (65), the funding of a Pooled Trust is exempt by Medicaid and not considered a transfer only if the disabled individual is under the age of sixty-five (65). Funding a Pooled Trust by an individual over the age of 65 will result in a Medicaid transfer penalty.²² This position may be the subject of litigation in the future.

Another type of Pooled Trust has recently come into favor and has been successfully used. It is called a "Pooled Income Trust." Such a trust becomes useful for an individual who has excess income after all exclusions have been used. A choice must be made whether the excess income is paid to the medical provider; thereby reducing the amount paid by Medicaid, or is paid into a Pooled Trust. If the income is paid into the Trust, the overage is eliminated and the income can be used to meet the supplemental needs of the beneficiary.

New York State Association of Retarded Children (NYSARC) which is a charitable organization has a Pooled Income Trust. A separate trust share account is established through the use of a joinder agreement with NYSARC Pooled Income Trust. Like all Pooled Trusts, the Pooled Income Trust must contain a payback provision. In the NYSARC Trust, the payback is to the NYSARC Guardian Trust, instead of to New York State (to reimburse the State for Medicaid provided to the Trust beneficiary).

This Trust should be discussed whenever there is a significant excess income situation with an individual with disabilities on Medicaid who is under the age of 65.

NYSARC--Pooled Income Trusts. On April 19, 2005, the New York State Department of Health authorized the use of the NYSARC Pooled Trust for the excess income of disabled individuals who are 65 or older.²³

Although OBRA 1993 eliminated the distinction between income and resources for Medicaid transfer penalty purposes by referring to both as assets, the Income Pooled Trust requirements clearly reestablish the distinction. The informational letter specifically permits the funding of excess income into the NYSARC Pooled Trust by disabled individuals over the age of 65, but makes the transfer of resources into said trust by said individual subject to the transfer penalty rules.

The disability determination is a prerequisite to funding a NYSARC Pooled Trust with the excess income of an individual over the age of 65. Unlike other disability determinations this determination can only be made by the State Disability review team in Albany. The submission process must include:

²² N.Y.S. Department of Social Services Administrative Directive: 96 ADM-8.

²³ 05 OMM/INF-1.

- a) a signed release of medical information;
- b) a completed and signed "DSS-1151" which is a Disability Interview form; and
- c) DSS Form 486T which is the Medical Report for Determination of Disability. This form must be filled out and signed by a doctor or a psychiatrist or a "qualified" psychologist.

These documents when completed must be submitted to the local Medicaid agency, who then forwards it to New York State Department of Health in Albany. All of the forms are available from the local Medicaid agency. It is significant that the State Disability Review Team has 90 days to approve or deny disability.

In order to become part of the NYSARC Pooled Income Trust, there is a "Joinder Agreement" that must be completed and submitted. A check in the sum of \$300 must accompany the Joinder Agreement. This check must come from the beneficiaries account, and must have the beneficiaries name printed on the check.

While the Medicaid application is pending, the beneficiary must pay a \$30 per month administrative fee to NYSARC to keep the Pooled Trust account active. These payments are not refundable even if the application is denied.

The Joinder Agreement should be completed by the attorney, whose name should be added as an authorized person. The completed disability form should be submitted with the Medicaid application.

Once approved by the local Medicaid agency and NYSARC the excess income can be transferred to the Trust and used to enhance the life of the beneficiary. For the individual receiving Medicaid home care, the NYSARC Pooled Trust can be particularly useful. It is common for the number of hours of approved home care to be inadequate to meet the needs of the individual. The excess income can be used to supplement the approved hours by paying for additional hours. There is a requirement in the Trust that the payments are made only to a certified agency, and further that payments be made by NYSARC directly to the certified agency.

NYSARC will accept the excess income during the period when Medicaid is pending. The use of the NYSARC Pooled Income Trust is recommended for clients who are 65 or older, disabled and have excess income under the Medicaid home care income budget.

VI. Third Party Supplemental Needs Trust

Third Party Supplemental Needs Trusts that are designed to supplement, but not duplicate or reduce, Medicaid benefits are often established by an individual with the individual's own assets for the benefit of a third party. This type of Trust is to be distinguished from a Special Needs Trust. Most frequently such Trusts are created by a

parent or grandparent with his or her assets for a child or grandchild with disabilities. The Trust is designed to prevent any payment made on behalf of the disabled beneficiary that could result in a reduction of benefits or termination of Medicaid eligibility. The funding of such Trusts will have no effect on the beneficiary's Medicaid eligibility because the beneficiary's money is not used to create the Trust. The language of a third party Supplemental Needs Trust can be based upon the suggested language of EPTL §7-1.12. The pay out restrictions and limitations of payments under a Supplemental Needs Trust can be similar or identical to the provisions of a Special Needs Trust. There is no Medicaid payback in a third party supplemental needs trust. The settlor can provide for the disposition of trust assets upon the death of the beneficiary, without any restrictions.

VII. Recovery of Medicaid properly paid: estate claims-- Age of 55 and older limitation

It is necessary to understand the age limitation of the Medicaid recipient on Medicaid estate recoveries. If an individual began receiving Medicaid at the age of 20, and dies at age 50 after receiving benefits for 30 continuous years, Medicaid has no claim against his estate because all Medicaid benefits were paid when he was under the age of 55. If however, the individual continued to receive Medicaid benefits until he died at the age of 56, Medicaid would have the right to place a lien against the estate, but that lien is limited to recovering Medicaid paid only during the last year, when the person was 55 and older (See 42 U.S.C.A. §1396p(b)(1)(B)). Thus, Medicaid benefits paid to an individual prior to age 55 are not subject to estate recovery and only the benefits paid when an individual was age 55 and older are subject to recovery.

Whenever a lien is placed against the estate of an individual who was age 55 or older when the Medicaid was paid, it is important to be certain that the lien does not include any assistance paid when the individual was younger than age 55.

Notes:

The above outline is based on New York law.

The above outline is in part excerpted from "*New York Elder Law and Special Needs Practice, 2009 Edition*" by Vincent J. Russo and Marvin Rachlin (Thomson Reuter), 1-800-328-4880.

Thanks to Marvin Rachlin for his assistance in preparing this outline.

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B. ATTORNEYS AS TRUSTEE

There has been an on-going discussion as to whether special needs attorneys should act as Trustee under Special Needs Trusts. Often, the attorney will be retaining the legal services of his or her law firm. This will create a number of issues the attorney will need to be clear with the creator of the Trust and the beneficiaries, since he or she may be wearing two hats with regard to the planning and administration of the trust.

The client has a number of choices when selecting a Trustee: Family members, friends, a corporate trustee or individual professionals, such as an attorney.

The following talking points identify some of the practical considerations of the attorney acting as a Trustee.

1. **Systems and Procedures.** The attorney must set up systems and procedures when acting as a Trustee. A separate matter number and file should be created, and time expended when acting as a Trustee should be tracked separately.
2. **Professional Advisors.** The attorney should seek appropriate professional counsel and services, which may include a financial advisor, accountant, health care providers etc.
3. **Trust Administration.** The attorney should consider retaining the services of a third party administrator for the handling of the day to day affairs of the Trust.
4. **Trustee versus Co-Trustee.** The attorney will need to consider whether he or she is willing to act as a Co-Trustee with another family member. What are the pros and cons of a Co-Trustee arrangement, as opposed to the attorney-Trustee acting alone. Will it make a difference if the Trustee's

role is further defined in the Trust Agreement such as a Distribution Trustee or an Investment Trustee.

5. **Bookkeeping and Accounting.** Will bookkeeping and accounting services be delegated to a staff person of the law firm, such as the bookkeeper or legal assistant?
6. **Investment of Trust Assets.** Is the attorney-Trustee prepared and equipped to deal with the investment of the Trust Assets? In light of the collapse of the stock market in recent months, are the attorney-Trustee experienced in how assets should be invested? What guidelines will the attorney-Trustee use in choosing among investment products?
7. **Distribution of Assets.** What guidelines will the attorney-trustee use in making distribution decisions? What if the attorney-Trustee distributes income or assets for a particular purpose and then later realizes that the distribution was inappropriate?
8. **Taxes.** The payment of taxes and the filing of tax returns will be the Trustee's responsibility. Is the attorney-Trustee prepared to understand and handle the tax issues while acting as Trustee?
9. **Communication with the Beneficiaries.** It will be the attorney's job to make sure that the beneficiaries (and the Settlor) are aware of the Trustee's duties and responsibilities. Will the attorney-trustee seek the beneficiary's approval before acting on certain matters?
10. **Conflicts of Interest.** The attorney as Trustee wears the fiduciary hat. He or she may also be providing legal services to the Trust.

A simple decision as to the amount paid to the law firm for legal services rendered to the Trust may pose an actual or potential conflict of interest. In order to eliminate actual and potential conflicts of interest, the Trust

instrument should specifically authorize attorney-Trustee commissions and permit the attorney-Trustee to hire his or her own law firm to provide legal services to the Trust. The Trust instrument should also specifically permit the attorney-Trustee's law firm to receive compensation for the legal services to be rendered. It is also highly recommended that the client execute an instrument of disclosure which specifically allows the attorney-Trustee to receive compensation and the attorney-Trustee's law firm to receive legal fees. The attorney-Trustee needs to decide which services are classified as Trustee services and which services are classified as legal services, which will generate a fee in addition to the Trustee compensation.

C. Supplemental Needs Trust Provisions Prepared by ElderCounsel, LLC

Section 1.01 Social Needs

It is important that Jim Jones is not isolated and that he is supported in his efforts to build a fulfilling life that includes meaningful social activities, social contacts, and leisure, recreation and travel experiences. Trustmaker encourages and supports Jim Jones's interests, hobbies, and choice of entertainment. In no event does Trustmaker want Jim Jones to feel so constrained by his financial status as a public benefits recipient that he is unable to enjoy these important life experiences.

Trustmaker recognizes and appreciates Jim Jones's strengths and capabilities and wholeheartedly supports his development to his full potential as well as his integration into the larger community of non-disabled persons. Trustmaker feels strongly that integration is essential to Jim Jones's development, and also helps others overcome their fears and prejudices about persons with disabilities.

The Trustee should make every effort to ensure that Jim Jones is involved in social activities including, but not limited to, participating in Special Olympics, participating in sporting activities, attending sporting events, participating in cultural activities, attending cultural events, participating in religious activities, and attending religious events.

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Section 1.02 Support Family Activities

Maintaining contact with family is of the highest priority. Trustmaker encourages Jim Jones to have regular visits with family; and Trustmaker supports the use of trust funds to facilitate such contact, if that becomes necessary. This also includes funds for family to visit Jim Jones. Trustmaker also directs funds to be used for Jim Jones to participate in family reunions, vacations or other family events.

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Section 1.03 Employment of Advocate

The Trustee may employ or retain the services of a qualified care manager or other person as an Advocate for Jim Jones's benefit. The Advocate shall provide advisement concerning Jim Jones's needs, rights, and entitlement to public benefits.

Section 1.04 Requirements for Advocate

If a care manager is employed or retained as the Advocate, he or she shall be a licensed clinical social worker, licensed care management agency, or registered nurse or similarly qualified professional who is familiar with public benefits rules and regulations and the developmental needs of persons with disabilities similar to Jim Jones's.

The Advocate shall be responsible for making recommendations as to what discretionary distributions should be made for needs not covered by public benefits, as well as recommendations concerning distributions otherwise covered by public benefits, including, but not limited to, payment for supplemental medical and therapeutic care, education and habilitation services, attendant care services whenever the need arises, residential services, and daily support services.

Section 1.05 Annual Care Plan

The Trustee shall have the option of requiring, in its discretion, the Advocate to provide an annual care plan to the Trustee and to Jim Jones. If Jim Jones is incapacitated, the care plan shall be provided to his parent or legal guardian.

The annual care plan should evaluate the status of Jim Jones's overall involvement in the community as well as health and well-being, particularly medical status.

Trustmaker wants to ensure that Jim Jones receives proper health care, including therapeutic care that may help him maintain and develop as much as possible. The care plan shall include recommendations concerning treatment, resources and services beneficial to Jim Jones. The annual care plan shall also include recommendations concerning unmet needs, if any.

Section 1.06 Personal Assessments

The Trustee shall have the option of requiring, in its discretion, the Advocate to visit Jim Jones on a regular recurring basis to assess his needs, including assessing required entitlements and resources, and maintaining a safe, healthy and comfortable living situation, and making and keeping necessary appointments. These visits shall include both announced and unannounced visits. If Jim Jones is not visited by caregivers at least monthly, then the Trustee shall require the Advocate to visit on a recurring basis that includes both announced and unannounced visits.

Section 1.07 Bank Account for Advocate

The Trustee may establish an account for part or all of the payments authorized under this agreement and direct that adequate funds, not to exceed that amount necessary for one month's care, be paid to this account for disbursement by the Advocate under the guidelines of **Error! Reference source not found.** The account shall be established as a separate bank account in the name of the trust, bearing the trust's federal tax identification number. At least monthly, the Advocate shall provide information on receipts and disbursements from this account to the Trustee. The Trustee shall be

indemnified for amounts paid from this account, until the Trustee receives the monthly accounting or has actual knowledge of the receipts and disbursements.

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Section 1.08 Trust Advisory Committee

This trust incorporates a Trust Advisory Committee. The responsibility of the Trust Advisory Committee is to advise the Trustee as to distributions that would be in Jim Jones's best interests. The Trust Advisory Committee serves in an advisory capacity only and its role is to make recommendations to the Trustee. The Trustee has discretion with regard to trust distributions. The Trust Advisory Committee members were chosen because of their knowledge and experience in assisting persons with disabilities and/or their personal interest in Jim Jones.

The Trust Advisory Committee shall consist of a minimum of three (3) members, and a maximum of seven (7) members.

There shall always be one professional member of the Trust Advisory Committee. The professional member shall be an individual or agency experienced with Medicaid and other programs of public benefits as well as Jim Jones's service needs and in addition shall be Clinical social worker, Care management agency, or Registered nurse. The initial professional member is Steve Person.

The initial non-professional Trust Advisory Committee members are Lois Myrne and Mary Murdoch.

Section 1.09 Distribution Advisement

The Trust Advisory Committee may advise the Trustee regarding distributions the Committee believes to be in Jim Jones's best interests. Before the Trustee makes distributions under any authority granted under this agreement, the Trustee may first consult with the Trust Advisory Committee and consider the Committee's advice and recommendations. If the Trustee so decides in the Trustee's discretion, the Trustee may make a distribution without contacting or soliciting the advice of any member of the Committee. Notwithstanding anything to the contrary, this Section in no way shall affect the discretion of the Trustee under this agreement.

(a) Distributions for Supportive Services

The Trust Advisory Committee shall determine when and if Jim Jones needs supportive services, including, but not limited to, employment of a care manager and/or supplemental attendant care, therapy, and educational assistance. The Trustee shall consider the advice of the Trust Advisory Committee with respect to the foregoing, but shall exercise its own discretion in making such distributions for supportive services.

(b) Major Purchases

The Trustee shall consider the advice of the Trust Advisory Committee on all major purchases, including, but not limited to, a primary residence or automobile. In the event that the Trustee purchases a primary residence, the Trustee shall have the discretion to allow Jim Jones to reside in the residence without payment of rent.

However, purchase of or payment for major medical equipment or Jim Jones's needs that are deemed necessary and appropriate by Jim Jones's physician or other medical professional, which are not available to Jim Jones through or covered by government benefit programs, shall not be restricted as a result of the provisions of this subparagraph, and will not be considered a Trust investment.

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D. Special Needs Trusts and Taxes

20:54. Use of Special Needs Trusts under OBRA 1993—Overview

Dramatic changes were made with regard to the treatment of Trusts for Medicaid eligibility purposes when the Omnibus Budget Reconciliation Act of 1993 ("OBRA '93") was signed into law by President Clinton on August 10, 1993. Many elder law practitioners considered this law to be an attack on Trusts, since many restrictions were placed on the use of Trusts within the context of the elder law practice.

The Special Needs Trust is a Trust funded with the assets of a disabled individual under the age of 65 which is established for the benefit of such individual by the parent, grandparent, legal guardian of the individual or a court, provided the state receives all amounts remaining in the Trust upon the death of the disabled individual, up to an amount equal to the total medical assistance paid on behalf of the individual.¹

The use of the Special Needs Trust can be an important planning tool to protect damages recovered in personal injury and medical malpractice lawsuits. This type of Trust can also be useful in the context of inheritances or to protect the assets possessed by a disabled senior at the time the disability is incurred.

Elder law attorneys are often asked by personal injury and medical malpractice attorneys to assist them in the structuring of the settlements of tort actions with the objective of optimizing the disabled person's recovery by maintaining eligibility for government programs such as Medicaid. This analysis must not only address entitlement planning, but also tax planning. The income, gift and estate tax implications of structured settlements need to be determined when the payments are made to a Special Needs Trust.²

It will be important for the elder law attorney to have a complete understanding of the tax and entitlement issues surrounding Special Needs Trusts. It is equally important to understand that the use of these Trusts under OBRA '93 presents a wonderful opportunity for all elder law practitioners to advocate on behalf of the disabled and insure them a better quality of life.

20:55. Use of Special Needs Trusts under OBRA 1993-- Income taxation

¹ See 42 U.S.C.A. §1396p(d)(4)(A).

² Hindert, Rehner, Hindert, Structured Settlements and Periodic Payment Judgments, (1994) (Law Journal Seminars-Press, originally published in 1986); and Howard J. Atlas and Vincent J. Russo, The Tax Implications of the OBRA-93 Disability Trust, (May 1995) (The ElderLaw Report, Volume VI, Number 10).

Settlement Payments to an Individual. When an individual is to receive payment of a monetary award, whether as a lump sum or as periodic payments, as a result of damages received from a personal injury or medical malpractice action, how is such an award to be treated for income tax purposes? Generally, gross income includes all income from whatever source derived.³ However, gross income does not include any damages received due to personal injury or sickness.⁴

Periodic payments can provide the individual with disabilities with an opportunity for federal income tax savings that does not exist with a lump sum settlement, since the interest realized from investing the lump sum is not excluded from gross income.⁵ Periodic payments, which include investment interest, are "exempt income" and thus are excluded from income taxation.⁶ One issue for the practitioner to consider is whether or not an assignment of the periodic payments to a Trust taints the tax exempt status of the payments.⁷ If payments are made to a "Grantor Trust" the payments should continue to be excluded because the disabled senior is treated as the owner of the Trust for income tax purposes.⁸

Punitive damages recovered in a case not involving physical injury or sickness may not be excluded.⁹ The law is currently unsettled however, as to whether punitive damages recovered in a case involving physical injury or sickness may be excluded from income. The IRS and the Tax Court have taken contrary positions. The IRS has stated that punitive damages are always included in gross income,¹⁰ while a federal district court in Alabama and the Tax Court have ruled that all punitive damages are excludable regardless of whether they are compensatory or not, as long as the underlying claim

³ 26 U.S.C.A. §61(a).

⁴ 26 U.S.C.A. §104(a)(2).

⁵ See Rev. Rul. 65-29, 1965-1 C.B. 59.

⁶ 26 U.S.C.A. §104(a)(2).

⁷ 26 U.S.C.A. §104(a)(2).

⁸ 26 U.S.C.A. §104(a)(2).

⁹ 26 U.S.C.A. §104(a).

¹⁰ Rev. Rul. 84-108, 1984-2 C.B. 32.

qualifies as a personal injury pursuant to I.R.C. §104(a).¹¹ There is a small, but growing number of cases supporting this exclusion.¹²

Settlement Payments to the Special Needs Trust. Once the payments from the settlements are funded into the Special Needs Trust, counsel must consider who will be taxed on the interest and dividends that the Trust assets generate. From a tax planning standpoint, under most circumstances, it is preferable for the tax to be reported by the disabled individual, instead of the Trust itself, since under current tax law the Trust tax brackets apply at lower levels of taxable income than for individuals.¹³ The 2010 federal income tax rates range from 10% to 35% for individuals and 15% to 35% for Trusts. An individual will reach a 35% tax bracket at \$373,651 of taxable income (in 2010), while a Trust will reach the same bracket at a taxable income of \$11,201 (in 2010).¹⁴

In order for the Trust income to be considered taxable to the disabled individual at the lower tax rate, the Trust must be considered a "Grantor Trust" for income tax purposes.¹⁵ To ensure Grantor Trust treatment, the disabled individual need not be named as grantor of the Trust document. The grantor of a Trust can be the senior who furnishes the Trust funds, not necessarily the individual named as grantor in the Trust agreement.¹⁶

A Grantor Trust can be best described as a Trust under which the individual has retained some level of interest or control in the Trust which causes the grantor to be considered the owner of the Trust property. To ensure that the disabled individual is taxed on the Trust income, it is critical that the Trust be drafted in accordance with the Grantor Trust rules.¹⁷

¹¹ See *Burford v. U.S.*, 642 F. Supp. 635, 86-2 U.S. Tax Cas. (CCH) ¶9724, 58 A.F.T.R.2d 86-5821 (N.D. Ala. 1986); *Miller v. C.I.R.*, 93 T.C. 330, Tax Ct. Rep. (CCH) 46021, Tax Ct. Rep. Dec. (P-H) 93.29, 1989 WL 104238 (1989), rev'd, 914 F.2d 586, 90-2 U.S. Tax Cas. (CCH) ¶50511, 66 A.F.T.R.2d 90-5620 (4th Cir. 1990).

¹² See *Horton v. C.I.R.*, 100 T.C. 93, Tax Ct. Rep. (CCH) 48856, Tax Ct. Rep. Dec. (RIA) 100.8, 1993 WL 28557 (1993), aff'd, 33 F.3d 625, 94-2 U.S. Tax Cas. (CCH) ¶50440, 74 A.F.T.R.2d 94-5934, 1994 FED App. 0301P (6th Cir. 1994).

¹³ 26 U.S.C.A. §1(a)-(e).

¹⁴ Rev. Proc. 2009-50.

¹⁵ 26 U.S.C.A. §§671 to 677.

¹⁶ See *Blackman v. U.S.*, 98 Ct. Cl. 413, 48 F. Supp. 362, 43-1 U.S. Tax Cas. (CCH) ¶10010, 30 A.F.T.R. (P-H) P 846 (1943); see also Priv. Ltr. Rul. 9004007.

¹⁷ 26 U.S.C.A. §§671 to 677.

The following are two suggestions for provisions the practitioner may want to utilize within the Trust document to secure Grantor Trust status:

1. The Trust may include a provision that would allow the disabled individual an unrestricted power to remove, substitute or add trustees and to designate any person including himself or herself as the replacement trustee. This type of power is deemed to be a "right to control the beneficial enjoyment of the Trust property."¹⁸ With this power, income will be taxed to the grantor.¹⁹

2. The Trust may provide the disabled individual with a certain administrative power, such as the power to reacquire Trust corpus by substituting other property of equal value.²⁰ With this administrative power, the Trust income will be taxed to the grantor.²¹

Furthermore the IRS has held that for income tax purposes a minor will be treated as the owner of a Trust which is created for the minor's benefit by court order as a result of a personal injury suit filed on the minor's behalf, if the Trust contains provisions that fall under the Grantor Trust rules.²²

20:56. Use of Special Needs Trusts under OBRA 1993-- Gift taxation

With regard to gift tax liability, one must determine upon the payment of settlement proceeds into the Special Needs Trust whether a completed gift has been made by the person with disabilities. Generally, the essential elements of a valid inter vivos gift are:

1. a donor competent to make the gift;
2. a clear and unmistakable intention on his or her part to make it;
3. a donee capable of accepting the gift;
4. a conveyance, assignment, or transfer sufficient to vest the legal title in the donee, without power of revocation at the will of the donor; and

¹⁸ 26 C.F.R. §1.674(d)-2.

¹⁹ 26 U.S.C.A. §674.

²⁰ 26 U.S.C.A. §675(4).

²¹ 26 U.S.C.A. §675.

²² 26 U.S.C.A. §§671 to 677; *see also* Rev. Rul. 83-25, 1983-1 C.B. 116; Priv. Ltr. Ruls. 9502019, 9502020, 9502024, 9502029 and 9502031.

5. a relinquishment of dominion and control of the subject matter by delivery to the donee.²³

The transfer of property constitutes a completed gift to the extent that the donor has parted with dominion and control of the property so as to leave him or her without a power to change the disposition, whether for his or her own benefit, or for the benefit of another.²⁴

Since the Special Needs Trust must provide for a pay back to the State for Medicaid paid during the individual's lifetime, the funding of the trust with the assets of the individual will be treated as an incomplete gift. Under Rev. Rul. 76-103, when a trust allows for the grantor's creditor to be paid from the trust, then the funding of the trust is an incomplete gift. In addition, if the Special Needs Trust provides for the trust assets to pass to the grantor's estate on his or her demise, then the trust assets will be treated as an incomplete gift due to this reversion.²⁵

To further substantiate this viewpoint, one could take the position that the funding of the Trust is part of a negotiated settlement and arguably not a gift by the disabled individual. Another position one could take is that the disabled individual did not intend to make a gift of the settlement proceeds since the Trust is created for the primary benefit of the individual who is disabled and no one other than such individual can benefit from the Trust during his or her lifetime, thereby rendering the funding an incomplete gift.

To avoid this issue entirely, the attorney should draft the Trust document properly to insure that the funding of the Trust is not a completed gift. If the individual who is disabled retains a power over the disposition of Trust assets, such as a testamentary power of appointment over the remainder upon death, then no portion of the funding should be considered a completed gift.²⁶

Even if the individual who is disabled does not have the requisite legal capacity to execute a Last Will and Testament and thus, cannot exercise the limited power of appointment, the funding of the Trust can still be considered an incomplete gift. Current case law and an IRS Revenue Ruling have taken the position that the mere possession at death of the power, rather than the exercise of, or inability to exercise the power, is the proper criterion to examine whether the transfer to the Trust is an incomplete gift.²⁷

²³ Edson v. Lucas, 40 F.2d 398, 8 A.F.T.R. (P-H) ¶10743 (C.C.A. 8th Cir. 1930).

²⁴ 26 C.F.R. §25.2511-2(b).

²⁵ Treas. Reg. §20-2511-2(c).

²⁶ 26 C.F.R. §25.2511-2(b), *see also* Priv. Ltr. Rul. 9437034.

²⁷ *See* Boeving v. U.S., 493 F. Supp. 665, 46 A.F.T.R.2d 80-6194 (E.D. Mo. 1980),

20:57. Use of Special Needs Trusts under OBRA 1993-- Estate taxation

Generally, if the individual who is disabled has retained an interest in the Trust or sufficient powers over the Trust property, then the Trust will be included in the estate of the person with disabilities.²⁸ All assets in which an individual has an interest at the time of death, are part of his or her gross estate for purposes of estate taxation.²⁹ Conversely, if the individual who is disabled has retained no interest in, or control over the Trust property, the funding of the Trust could be considered a completed gift subject to gift tax and not part of the estate for estate tax purposes. As a result, the drafting of the Trust agreement can have a significant impact on the gift and estate tax consequences of the Trust.

Assets of the Special Needs Trust will be included in the estate of the individual who is disabled if: (i) the Trust assets will be distributed to his or her estate;³⁰ or (ii) that individual retains a limited power of appointment over the trust assets. Drafting the Trust to allow the individual who is disabled the power to determine who will receive the remainder of the Trust property at his or her death, would cause estate inclusion pursuant to I.R.C. §2036(a)(2).

The IRS has officially agreed with this position in a private letter ruling.³¹ This private letter ruling involved a personal injury settlement paid into an Irrevocable Trust for the benefit of a child who is disabled. The IRS held that the Trust assets were includable in the disabled child's estate since the decedent child retained a special testamentary power of appointment over the Trust (the power to alter the disposition of the Trust corpus at his death). Thus, the transfer of the funds into the Trust constituted an incomplete gift³² and the Trust corpus was includable in the child's estate.³³

decision rev'd, 650 F.2d 493, 81-2 U.S. Tax Cas. (CCH) P 13415, 48 A.F.T.R.2d 81-6248 (8th Cir. 1981); *Alperstein v. C. I. R.*, 613 F.2d 1213, 80-1 U.S. Tax Cas. (CCH) P 13326, 45 A.F.T.R.2d 80-1708 (2d Cir. 1979); Rev. Rul. 55-518, 1955-2 C.B. 384.

²⁸ 26 U.S.C.A. §§2033 to 2041.

²⁹ 26 U.S.C.A. §2033.

³⁰ I.R.C. §2037

³¹ Priv. Ltr. Rul. 9437034.

³² 26 U.S.C.A. §2511.

³³ 26 U.S.C.A. §2038.

In Technical Advice Memorandum 9506004, issued November 1, 1994, the Internal Revenue Service took the position that the settlement proceeds of a tort action brought on behalf of a minor and placed in two irrevocable Trusts by his guardians were includable in the minor's gross estate for estate tax purposes. The proceeds were includable not only under I.R.C. §2038 due to a testamentary power of appointment, but also under I.R.C. §2036 because the Trust corpus could be consumed for the minor's needs. Under the terms of the Trust agreement, the trustees had broad discretion to distribute income or principal for the minor. In a recent U.S. Court of Claims case, the Court held that the Trust assets of a Supplemental Needs Trust were included in the decedent's estate for estate tax purposes.³⁴

If the estate of an individual who is disabled is valued under the applicable exclusion amount (\$3,500,000 in 2009), then there is no federal estate tax.³⁵ If the date of death value of the Trust is over the applicable exclusion amount, then the attorney must consider debts and expenses which will reduce the gross estate subject to tax. These include the claim of the State for medical reimbursement under the Medicaid program, as well as other debts and administrative expenses, which will reduce the gross estate³⁶ subject to estate taxation. If the estate is reduced to the applicable exclusion amount (\$3,500,000 in 2009) or less, then there would be no federal estate tax to be paid because of the applicable federal applicable exclusion.³⁷

Estate Inclusion--Future Periodic Payments. If a personal injury lawsuit settlement is structured so that annuity payments continue to be paid to a disabled individual's parents upon his or her demise, the present value of the annuity payments to be received by the parents (the remainder beneficiaries) is included in the decedent's estate.³⁸

Since the remaining annuity payments are includable in the disabled individual's estate, the continued payment stream must be valued. There are three potential approaches to valuing the amount to be included in the decedent's estate:

³⁴ Arrington v. U.S., 34 Fed. Cl. 144, 95-2 U.S. Tax Cas. (CCH) ¶60212, 76 A.F.T.R.2d 95-6762 (1995), aff'd, 108 F.3d 1393, 97-1 U.S. Tax Cas. (CCH) ¶60260, 79 A.F.T.R.2d 97-1341 (Fed. Cir. 1997).

³⁵ 26 U.S.C.A. §2010.

³⁶ 26 U.S.C.A. §2053.

³⁷ Please note that an estate of \$3,500,000 would generate a New York State estate tax of \$229,200.

³⁸ 26 U.S.C.A. §2039.

1. The cost of a commercial annuity;³⁹
2. The value based on discounting future payments at 120% of the average federal midterm rate⁴⁰ on the date of death;⁴¹ or
3. The price a willing buyer would pay a willing seller for the right to receive future payments.⁴²

Although not involving periodic payments of personal injury settlements, two Tax Court cases valued continuing annuity payments at the cost of a commercial annuity and not pursuant to the willing buyer/willing seller rule.⁴³ It is likely that the IRS will utilize the commercial annuity valuation or at a minimum, the valuation specified under I.R.C. §7520 and resist applying the willing buyer/willing seller approach.

If the settlement is structured as a payment stream which continues paying the deceased disabled individual's family over a number of years, there may be insufficient Trust assets to pay the estate tax which is due within nine months after the decedent's death. Under this scenario, the estate may request that the estate tax be paid in installments over time.⁴⁴ If the IRS grants this request, there will be no penalty for not paying the estate tax within nine months from the decedent's date of death, but interest will have to be paid on each installment.

20:58. Third-Party Trusts

Third-Party Trusts are set up by the grantor for the benefit of a third party. Typical situations in which Third-Party Trusts are used in an elder law practice would be where: (a) a spouse sets up a Trust for the benefit of the other spouse; (b) a child sets up a Trust for his or her elderly or disabled parent; or (c) a parent sets up a Trust for the special needs of a disabled child. The Trust usually provides for discretionary powers in the trustee to utilize income or principal for the benefit of a primary beneficiary, without

³⁹ 26 C.F.R. §20.2031-7.

⁴⁰ The federal midterm rate is promulgated on a monthly basis. *See* Rev. Rul. 2006-07 for February 2006 Rates. This rate is to assist in valuations for gift and estate tax purposes.

⁴¹ 26 U.S.C.A. §7520.

⁴² 26 C.F.R. §20.2031-1(b).

⁴³ *Estate of Bell v. U.S.*, 80-2 U.S. Tax Cas. (CCH) ¶13356, 46 A.F.T.R.2d 80-6148, 1980 WL 1700 (E.D. Wash. 1980); *Estate of Raimondi v. C.I.R.*, T.C. Memo. 1970-25, T.C.M. (P-H) ¶70025, 29 T.C.M. (CCH) 70, 1970 WL 1529 (1970).

⁴⁴ 26 U.S.C.A. §6166.

replacing any government benefits. This type of Trust is sometimes referred to as a "Third-Party Supplemental Needs Trust." This type of Trust can be invaluable in protecting assets in the event that the third-party/beneficiary requires long term care.⁴⁵

All of the Trust tax rules apply to the Third-Party Trust. Hence, taxation may depend upon on a number of factors such as grantor retained powers.

Notes:

The above outline is based on New York law.

The above outline is in part excerpted from "*New York Elder Law and Special Needs Practice, 2010 Edition*" by Vincent J. Russo and Marvin Rachlin (Thomson Reuter), 1-800-328-4880.

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⁴⁵ Estates, Powers and Trust Law §7-1.12 (McKinney's 1996 Interim Update); *see also* Estate of Escher, 94 Misc. 2d 952, 407 N.Y.S.2d 106 (Sur. Ct. 1978), decree aff'd by, 75 A.D.2d 531, 426 N.Y.S.2d 1008 (1st Dep't 1980), order aff'd, 52 N.Y.2d 1006, 438 N.Y.S.2d 293, 420 N.E.2d 91 (1981).

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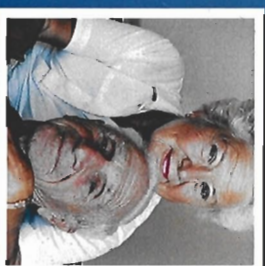
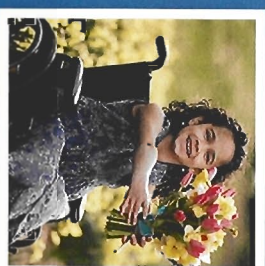
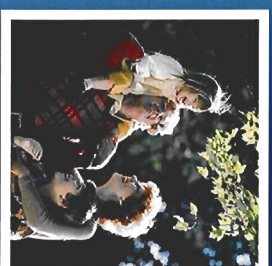
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