
THE INTERSECTION OF TRUST, TAX AND PUBLIC BENEFITS LAW

A. INTRODUCTION

In order to properly advise an elderly or disabled client, the elder law attorney must be thoroughly familiar with (1) the benefits available to the client; (2) the eligibility requirements for programs providing the benefits; (3) the tools which facilitate eligibility for the programs; and (4) the tax considerations when determining to implement a specific planning tool. Benefit programs for the elderly and disabled vary significantly, as do the tools which may be utilized to obtain eligibility. Attempting to use the wrong tool for a specific facts situation is like trying to fit a round hand grenade into a square hole: It won't work and will probably explode in the process.

This paper will address (1) the four most popularly utilized public benefit programs; (2) the trusts generally implemented to acquire eligibility for the programs, if any; (3) the sources of law which govern the use of trusts in elder law planning; and (4) the basic tax rules which apply to trusts and elder law planning in general.

It is imperative to understand two concepts: (1) While some of the programs and underlying laws and regulations have their base in the federal system, many eligibility rules are specific to the states and do not apply in all cases; and (2) the rules involved in the programs discussed are changing on a more than annual basis. For instance, "income first" has all but eliminated "resource first" in Medicaid planning in the past 2 years. Estate recovery rules have continued to expand. The traditional "look-back" and transfer rule calculations have been completely overhauled under the Deficit Reduction Act of 2005. It is absolutely necessary to understand the current status of the law regarding the program rules that you are attempting to use, as well as the specific laws in your state which apply to eligibility for that particular program.

The law which applies to Wills and trusts has been traditionally stable. Wills have testators, executors and beneficiaries. Trusts have settlors, trustees and beneficiaries. Unfortunately, however, we are in the midst of a time where the wealthy, big business and insurance companies are firmly in control. One need to look no further than massive tort reform, erosion of the jury trial system, overhaul of the bankruptcy system and unfathomable cuts in public benefits for the poor, elderly and disabled.

Trusts have historically been a method whereby the owner of assets can pass them down to the next generation, or gift them to someone of the owner's choosing, in such a manner as to allow benefit to the intended beneficiary without risking that the assets would be wasted by involuntary attachment by the beneficiary's creditors. After all, the assets are owned by the settlor – not the beneficiary – and they are intended to be used for the benefit of – not owned by – the beneficiary. Because of the political control of banks, the insurance industry and big business in general, the laws which have traditionally protected third-party transfers in trust are being challenged, and in some cases, eliminated. Every trust practitioner must be familiar – and keep current – with (1) individual state laws regarding "spendthrift provisions" and (2) the implementation of the Restatement of the Law, 3d: Trusts (commonly referred to as "Restatement of Trusts 3d")¹ or (3) the Uniform Trust Code² (or a variation thereof) in that state. Statutes being

¹ *Restatement of the Law, Third: Trusts* (American Law Institute 2003).

adopted in some states create various classes of “exception creditors” who are allowed to invade traditionally creditor protected trusts for satisfaction of their claims. Estate planning and elder law attorneys who practice third-party disability trust planning should understand the issues involved in the national debate as to whether trust assets can be determined by a court to be “available resources” to the disabled trust beneficiary.

While a detailed discussion of the Uniform Trust Code (hereafter “UTC”) and the Restatement of Trusts 3d (hereafter “Restatement 3d”) is beyond the scope of this article, it is imperative that trust practitioners be aware of the controversy between those who believe that traditional trust spendthrift laws should be uncompromised and those who believe that creditors, courts and legislatures should have the freedom to define the extent to which spendthrift protection may be eliminated. Certain provisions of the UTC and the Restatement 3d have been referenced as threats to our use of trusts to accomplish effective public benefits planning. Therefore, in addition to a general discussion of utilizing trusts to assist in qualifying for public benefits, this article will discuss an overview of the issues involving public benefits trusts in UTC and Restatement 3d states.

B. DEFINITIONS

The following list includes words, concepts, cases and laws which must be understood in order to successfully practice elder law. While this list is not meant to be exhaustive, an understanding of these concepts will put the practitioner far ahead of the game as he or she attempts to master the area of public benefits law.

1. Elder Law Terminology Defined

a. *Blumer [Wisconsin Dept. of Health & Family Services v. Blumer]*

In a 6 - 3 decision (February 20, 2002), the United States Supreme Court approved the use of the “income first” approach by states in calculating the amount necessary to satisfy the community spouse’s MMMNA (Minimum Monthly Maintenance Needs Allowance).

b. Community Spouse

In spousal cases, the husband or wife who will be remaining at home while the other spouse enters the nursing home receiving Medicaid benefits is called the “Community Spouse” or “CS.”

c. Complex Trust

Any trust that is not a simple trust for the year (because it either may accumulate income, provides for charity, or actually made distributions exceeding current income).³

² *Uniform Trust Code* (National Conference of Commissioners on Uniform State Laws, as last amended 2005.)

³ Jeffrey N. Pennell and Alan Newman, *Estate and Trust Planning* (ABA Publishing, 2005), at 481; IRC, Subchapter J, Subpart C, §§661-664).

d. DRA 2005 [Deficit Reduction Act of 2005]

The Deficit Reduction Act of 2005 severely limits the ability to make transfers prior to applying for nursing home Medicaid benefits by (1) extending the “look-back” period from the traditional 36 months to 60 months in all cases and (2) moving the beginning date of any transfer penalty from the traditional date of transfer to a date at or near the time of application for benefits.

e. Deeming

Generally used in SSI cases, the income and resources of a third party may be deemed, or counted against an applicant in calculating whether or not the applicant meets the income or resource test of Medicaid eligibility.

f. Disability

The individual must be unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment that can be expected to result in death or has lasted or can be expected to last for a continuous period of at least 12 months.

g. Foster Care Independence Act of 1999

Imposed periods of ineligibility (transfer penalties) for transfers for less than fair market value during the applicable look-back period against applicants for SSI benefits. There had been no transfer penalties for SSI applicants prior to this law.

h. Grantor Trust Rules

The owner of a beneficial interest in trust property is required to include the income derived from such trust property as part of the owner’s income for tax purposes. The grantor trust rules are used to define who will be treated as the owner of trust assets for income tax purposes. The general rule is that a grantor should be able to enjoy the benefits of a trust while someone else is charged with the income taxes.

i. HCFA Transmittal 64

HCFA 64 contains the regulations which interpret the trusts authorized under OBRA 93. OBRA 93 creates the exceptions to the general rule that transfers of an individual’s own assets will result in a penalty period of ineligibility. HCFA 64 details the regulations which apply to these trusts.

j. I.S.M. [In-kind Support and Maintenance]

When a SSI recipient receives support benefits from a third party, by having a third party pay the provider directly, the support benefit received is defined as “in-kind support and

maintenance.” The benefits are calculated using the “presumed value rule” and result in a reduction of the monthly case benefit, but not disqualification from the program.

k. Income First

“Income First” is one of two generally accepted methodologies for satisfying the MMMNA requirements for a community spouse when calculating the Community Spouse Resource Allowance (CSRA) in spousal Medicaid cases. Income First requires that income of the Institutionalized Spouse (IS) be transferred to the Community Spouse (CS) prior to the transfer of any assets owned by the IS to the CS.

l. Institutionalized Spouse

In dealing with Medicaid applicants in spousal cases, the individual who will be entering the nursing home and receiving Medicaid benefits is referred to as the “Institutionalized Spouse” or “IS.”

m. Look-Back Period

When calculating transfer penalties for Medicaid and SSI purposes, the only transactions which are considered are those gifts which were made during the applicable look-back period. Traditionally, the look-back period for transfers to individuals has been 36 months and 60 months for transfers into trust. DRA 2005 makes the look-back period 60 months for all transactions.

n. MCCA 1988 [Medicare Catastrophic Coverage Act of 1988]

MCCA 1988 established the “spousal impoverishment” rules which recognized the need to provide a certain amount of income for the community spouse to ensure a reasonable quality of life for the spouse at home after the institutionalized spouse has qualified for nursing home Medicaid.

o. MMMNA [Minimum Monthly Maintenance Needs Allowance]

The Minimum Monthly Maintenance Needs Allowance (MMMNA) is the minimum amount of monthly income allowed to the community spouse under the spousal impoverishment rules set out in MCCA 1988.

p. Means Tested

A “means tested” program is one which has requirements dealing with income and resources which must be met by any applicant for benefits under that program. SSI and Medicaid are the two most common means tested programs. Applicants for these programs must have monthly income and countable resources below the levels set by the program in order to be eligible for benefits.

q. Non-Means Tested

A non-means tested program is one which is categorized as an “entitlement.” The assets owned by the applicant are irrelevant to qualification. Eligibility is based upon other factors. Medicare and Social Security Disability are the primary nonmeans tested programs.

r. OBRA 93 [Omnibus Budget Reconciliation Act of 1993]

OBRA 93 established certain trusts as exceptions to the general rule that transfers of one’s own assets are subject to a transfer penalty. The primary trusts are the Special Needs Trust, the Qualified Income Trust, and the Pooled Trust. Lesser used trusts are the Income Only Trust, the Sole Benefit Trust and the Disability Annuity Trust. The regulations for the OBRA 93 trusts are found in HCFA Transmittal 64.

s. Presumed Value Rule / One-Third Reduction Rule

In the S SI context, whenever a third party provides support benefits (food or shelter) to the recipient by paying a vendor or providing the benefits himself, monthly income check of the SSI recipient is reduced. Rather than calculate the value of the support need actually provided, the value is presumed to be one-third of the monthly SSI check. Accordingly, the recipient’s SSI check is reduced by one-third for the month in which the support need was provided.

t. POMS [Program Operations Manual System]

The POMS is the set of rules used by the Social Security Administration is administering the SSI program. Even though this is not law, SSA workers will usually follow the POMS without regard to its conflict with current statutory and case law. The POMS is now available on line.

u. PRA [Protected Resource Amount]

Under the doctrine of “Spousal Impoverishment (MCCA 1988), the community spouse is entitled to retain a certain amount of resources, irrespective of what methodology is used to calculate that amount. There is a minimum and maximum set each year. The amount set aside to the CS when the IS qualifies for nursing home Medicaid is the PRA.

v. Resource First

The CS is allowed an amount of income (MMMNA) as well as an amount of resources (PRA) when the IS qualifies for nursing home Medicaid. The methodology that allows the resources of the IS to be transferred to the CS, resulting in a calculation of interest income to reach the MMMNA is called “Resource First.” This method does not require income attributable to the IS to be transferred to the CS in an effort to obtain the MMMNA prior to assets being utilized to achieve the minimum income amount.

w. Self-Settled Trust

This is a trust which is funded using the beneficiary's own money. The primary example in the elder law practice is the "Under 65 Disability Trust (d4A Special Needs Trust)" into which money attributable to the disabled individual is conveyed.

x. Simple Trust

A simple trust is one whose terms *require* that the trust (1) must distribute all current income annually; (2) must make no distributions for the year in excess of the amount of current income; and (3) may make no charitable distributions or set asides.⁴

y. Third-Party Trust

This is a trust which is funded using the money of someone other than the beneficiary. An example is a parent setting up a trust for a disabled child and gifting money into the trust (Third Party SNT).

z. Transfer Penalty

In the context of Medicaid or SSI, a transfer penalty, or period of ineligibility for benefits, is assessed when the applicant for benefits has made a transfer for less than fair market value to a third party or to a trust during the applicable look-back period.

aa. *Uniform Trust Code*

That code of the same name adopted by the "National Conference of Commissioners on Uniform State Laws" as originally adopted or as subsequently amended.

bb. 42 U.S.C. 1396p(d)

OBRA 93 established exceptions to the general rule which would otherwise define a self-settled trust as a transfer resulting in a penalty period being assessed. The specific law defining the three most common types of trusts is 42 *U.S.C. 1396p*. The sub-sections under this provision are (d)(4)(A), (d)(4)(B) and (d)(4)(C), with which every elder law attorney must be familiar by name and number.

⁴ Pennell and Newman, *supra*. at 478; Treas. Reg. §§1.651(a)-1(b). My good friend Mark Cohen recently pointed out that my previous definition of "Simple Trust" did not properly address issues of capital gains and trust accounting income. Thus, in digging for a more thorough explanation, I discovered this definition on page 480 of the Pennell/Newman treatise: "The tax consequence of qualification as a simple trust to beneficiaries entitled to receive required distributions of income is §652(a) inclusion in income of the amount allowed as a deduction to the trust, whether the income actually was distributed or only required to be distributed." For a more detailed discussion, see Chapter 20 of that book entitled "Income Taxation of Estates, Trusts, Grantors and Beneficiaries."

cc. (d)(4)(A) Trust

The self-settled, under 65 disability trust commonly referred to as a Special Needs Trust, with “pay back” provision.

dd. (d)(4)(B) Trust

The “Miller Trust” or “Qualified Income Trust” which allows individuals in “Income Cap” states to qualify for nursing home Medicaid even though their countable income exceeds the applicable income cap.

ee. (d)(4)(C) Trust

The “Pooled Trust” which allows the Medicaid applicant’s money to be conveyed to a non-profit corporation.

C. TRUSTS AND PUBLIC BENEFITS

Public benefits programs are generally divided into two categories. The program is either “means Tested” or “Non-means Tested.” In order to effectively plan for achieving disability planning goals, the attorney must understand the programs and how eligibility can be impacted by the proper use of trusts.

Trusts are primarily used in disability planning to allow an individual either to qualify for, or maintain eligibility for, a public benefit program. The most common public benefit programs are (1) Medicare, (2) Social Security Disability (SSD), (3) Medicaid and (4) Supplemental Security Income (SSI) and (5) Federally-assisted Housing. Trusts are very useful in planning for certain benefits and are irrelevant to planning for other programs.

A “means tested” program is one which has requirements dealing with income and resources which must be met by any applicant for benefits under that program. Applicants for these programs must have monthly income and countable resources below the levels set by the program in order to be eligible for benefits. The primary “means tested” public benefit programs are (A) Medicaid and (B) Supplemental Security Income (SSI).

A “non-means tested” program is one in which the assets owned by the applicant are irrelevant to qualification. Eligibility is based upon other factors. The primary “non-means tested” public benefit programs are (A) Medicare and (B) Social Security Disability (SSD).

As a general rule, disability planning with trusts applies only to “means tested” programs. In order to facilitate eligibility for public benefits, trusts maybe used to limit countable income or to limit countable resources. As described in more detail below, individuals who are aged, blind or disabled and who have few assets and low income may qualify for public benefits which they need but cannot afford. The primary benefit is health care, through Medicaid. SSI recipients also receive monetary benefits.

If an applicant receives too much income or owns assets of too much value, that individual will not qualify for the public benefit program. For example, if a single mom is seriously injured in an automobile wreck which renders her permanently disabled, but she receives a substantial injury award, she will not qualify for Medicaid benefits under the SSI program because she now has too much money. Unfortunately, her money will be spent on medical care and she will not have any money left for quality of life benefits. If the law suit recovery was not counted in the eligibility process, she would qualify for SSI benefits.

In the example discussed above, a trust can be established for the benefit of the disabled mom which will allow her to both (1) qualify for public benefits, including health care and (2) use the award for quality of life benefits. This trust is called a Special Needs Trust. It is authorized by federal statute and recognized for both Medicaid and SSI purposes.⁵ Proper use of this trust, as well as the other trusts discussed below, allow income and resources to be categorized as “non-countable” when the same income or resources would otherwise disqualify the individual from receiving benefits.

One trust – the Miller Trust – is an “Income Trust” which is used for income qualification in “Income Cap” states. The other trusts – Resource Trusts – are implemented to own assets which may be used to benefit the applicant, but which will not be counted against the applicant for eligibility purposes. The trusts from each category are listed below.

1. The Income Trust
 - a. Miller Trust⁶
 - (1) Also referred to as “Qualified Income Trust
 - (2) Also referred to as “d4B Trust”
2. The Resource Trusts
 - a. Under 65 Special Needs Trust⁷
 - b. Third-Party Special Needs Trust
 - c. Purely Discretionary Trust
 - d. Income Only Trust
 - e. Pooled Trust⁸

D. THE “MEANS TESTED” PROGRAMS

1. Medicaid

Medicaid is a public benefit program which provides medical care and custodial care for individuals who could not otherwise afford to pay for these benefits. Although there are numerous Medicaid programs, the most widely visible benefit is “long-term nursing home” Medicaid. Medicaid is viewed as the

⁵ 42 U.S.C. 1396p(d)(4)(A).

⁶ 42 U.S.C. 1396p(d)(4)(B).

⁷ 42 U.S.C. 1396p(d)(4)(A).

⁸ 42 U.S.C. 1396p(d)(4)(C).

government program which pays for the elderly destitute to live in a nursing home and receive skilled nursing care and necessary prescription medications without the requirement of co-pays.

As described in more detail below, only individuals with low income and very low asset value can qualify for Medicaid. Trusts are used to readjust countable income and reclassify resources to the extent that individuals who could not otherwise afford these necessary benefits and could not qualify for Medicaid will become a qualified applicant. Medicaid is a complicated program based upon mountains of federal and state rules and regulations. A brief description of those rules are set out below.

Unlike Medicare, Medicaid is a joint federal - state program. The fundamental rules are found in federal statutes. As long as the states do not violate the basic federal rules, they are free to write their own eligibility and administrative rules. For that reason, Medicaid rules vary significantly from state-to-state.

While references to Medicaid immediately invokes thoughts of elderly people in nursing homes, there are actually numerous programs available to benefit various classifications of needy individuals. In Elder Law, the majority of the focus is usually upon (1) Long-term nursing home Medicaid and (2) SSI-related Medicaid. Medicaid programs are “means-tested” indicating that successful applicants must have (1) low income and (2) a very low level of resources.

a. Medicaid Benefits

Medicaid provides comprehensive medical benefits, including (1) Physician services; (2) Hospital and Outpatient services; (3) Prescription medications; (4) Some limited in-home services; and (5) No “co-pays” or “deductibles.” (watch DRA 2005)

b. Basis of Medicaid Eligibility

The rules which govern Medicaid eligibility are voluminous and complex. The applicant must qualify under federal and state-specific Medicaid rules. Most eligibility rules are based upon state law. As long as states do not violate the general applicable federal rules, each state is allowed to write it’s own specific rules of Medicaid eligibility. The federal rules are promulgated by statute (i.e. U.S. Code). The “regulatory” agency for the setting federal Medicaid policy is the Center for Medicare and Medicaid Services (CMS), formerly called the Health Care Finance Administration (HCFA).

There are two primary tests for Medicaid eligibility. These tests are the income test and the resource test. This is true on both the federal level and in each state. The state rules vary significantly, however. In order to qualify for benefits, the applicant must satisfy both tests. Applicants will either be (1) a single individual, (2) a married individual or (3) a married couple. The rules which apply to a single individual applicants are substantially different from those which apply to a married applicant and even different still from a married couple applying together. While a comprehensive discussion of Spousal Impoverishment is beyond the scope of this paper, it is imperative that every elder law attorney understand how those rules apply to married applicants, how to apply “income first” and “resource first” and how DRA 2005 affects eligibility.

(1) Income Test

States either choose their income methodology by electing to be classified as a “medically needy” state or an “income cap” state. There are only 19 “income cap” states. In “medically needy” states, the income requirement is based upon actual medical needs in relation to available income. In “income cap” states, the income requirement is based upon an income cap amount set every year. That amount is 3 times the monthly SSI benefit amount. The 2009 monthly SSI benefit amount is \$674. Therefore, the 2009 income cap is \$2,022. If an applicant’s income exceeds the income cap, it is necessary to implement a “Miller Trust” in order to satisfy the Medicaid income test.

Income is determined by what is called “the name on the check” rule. Income is not combined (or “deemed”) between spouses. Only income attributable to the Medicaid applicant (i.e. Is it the applicant’s name which appears on the monthly check?) is considered for eligibility calculation purposes. For purposes of Medicaid eligibility, only permanent monthly income items are counted. These include primarily Social Security checks, retirement pension checks and Veteran Administration checks.

(2) The Resource Test (The term “Resources” = “Assets”)

Resources are divided into 2 groups. An asset is either “countable” or “non-countable.” If the asset is “non-countable,” the value is not considered when determining the countable resource limit. The general rule is that the applicant can have no more than \$2,000 in countable resources, if applying individually, or no more than \$3,000 of countable resources for a married couple. The general rule has been that the applicant can have an unlimited amount of non-countable resources, as defined under the rules. DRA 2005 changes this rule by placing maximum value limitations on some resource, such as the homestead.

Lawyer Beware: The resource classification rules vary dramatically from state to state. Additionally, the state may change the rule with little notice. For instance the rule for several years has been that only one vehicle is non-countable and the value could not exceed \$4,500 unless the vehicle was used for medical transportation. The rule was recently changed to one vehicle of any value for most states. But in Maryland, the applicant can have multiple vehicles. Be particularly careful if your clients are coming from, or planning on moving to, another state and plan to become or remain eligible for Medicaid.

Lawyer Beware: While the general rule has traditionally been that the applicant can own an unlimited amount of “non-countable resources, there may be limitations on “non-countable” resources for valuation purposes. In most states, the residence has traditionally been exempt, irrespective of value. But under DRA 2005, the value of the residence cannot exceed \$500,000 unless the state adopts a higher value limit, not to exceed \$750,000.

The “non-countable” resources (in most - but not all - states) are (1) The residence (1 only) [Pre-DRA is “of any value.” DRA 2005 limit is \$500,000 with a state option to raise the limit to \$750,000. States vary on occupancy requirement; currently, there is no occupancy requirement in Texas; only requirement of “intent to return home.” The statutory definition includes all continuous real estate, with no limit on acreage. (2) One vehicle used for transportation, regardless of value. (3) Household goods and furnishings [For a single individual the limit is \$2,000. For a married couple with a spouse in the community, there is no limit]. (3) Property used in trade or business. (4) Burial plots [Number of plots allowed varies by state; in Texas, the applicant is allowed 1 plot for each member of the “immediate family” as defined by statute]. (5) “Pre-need” burial plan [Number of burial plans allowed varies by state; in Texas, the applicant is allowed 1 burial plan for each member of the “immediate family” as defined by statute] . (6) Life Insurance: Term Insurance is not counted, irrespective of face value of policy. The cash value of a permanent policy is counted as a resource unless the total face value of all cash value policies is less than \$1,500 in which case the cash value is not countable.

All assets not categorized as “non-countable” are “countable.” While some assets present no problem to define (i.e. cash), other assets, such as “annuities” involve complex rules when attempted to determine if the asset is a countable resource, countable income or an asset whose purchase results in a transfer penalty.

In addition to the general rules set out above, the elder law practitioner must be thoroughly familiar with (1) spousal impoverishment rules, (2) the “income first” methodology, (3) the “resource first” methodology, (4) utilization of the Community Spouse’s PRA and MMMNA, (5) transfer penalties, including statutory exceptions (i.e. child living with parent and caring for them for at least 2 years in lieu of institutionalization) and (6) treatment of special assets, such as annuities and notes (especially in light of DRA 2005).

2. Supplemental Security Income (SSI)

Supplemental Security Income (hereafter “SSI”) is a federal poverty program for individuals who are either aged, blind or disabled.⁹ The rules which govern the program are found in federal statutes.¹⁰ The unofficial regulations for the SSI program are found in the Program Operations Manual System (hereafter “POMS”). As a welfare model program, SSI is means tested. The successful SSI applicant must have low income and a very low level of assets.

The federal statutes of SSI are found at 20 CFR §416.¹¹ A version of the POMS for the public can be found at www.ssa.gov.¹² In addition, there are regional POMS which control the decisions of the SSA in various parts of the country. While the POMS do not have the force of law, any experienced SSI practitioner will confirm that familiarity and conformity to the POMS is a practical necessity.

⁹ POMS, SI 00501.001

¹⁰ 20 CFR §416

¹¹ There is an electronic version of the CFR on the web which can be found at <http://ecfr.gpoaccess.gov>.

¹² To access the POMS at www.ssa.gov, do a search at the site for “POMS.”

SSI eligibility has three sets of requirements: Categorical, Residential and Financial. Although trusts only deal with the financial aspects of qualifying for SSI. All three categories must be satisfied.

a. SSI Benefits

SSI payments are intended to provide income to be used for food and shelter.¹³ It is a welfare model program for the poor which is intended to provide income equal to 75% of the federal poverty level. The rules used in calculating the amount of monthly SSI payment due to the recipient include (1) deductions for countable income paid to the recipient; (2) classification of income received as either “earned” or “unearned” income; (3) income received by others as “deemed” to the recipient; and (4) classification of support benefits received as “in-kind support and maintenance” [ISM]. For 2009, the maximum monthly payment is \$674 for an individual and \$1,011 for a married couple who both qualify. The amount is adjusted annually.¹⁴

If the SSI recipient receives at least \$1 in SSI benefits, he also receives Medicaid coverage. In addition to the federal benefit amount, some states pay a supplemental amount administered by the Social Security Administration. Information on state supplement programs is available at www.ssa.gov/notices/supplemental-security-income/text-understanding-ssi.htm. In many states, the beneficiary will also automatically qualify for food stamps and Medicaid coverage.

b. The basis of SSI eligibility

The five SSI eligibility requirements are classified as (1) Categorical, (2) Residential, (3) Financial, (4) Alternate Program Eligibility and (5) Non-institutionalization.

(1) Categorical Requirements.

The SSI applicant must be either (1) age 65 or older, (2) blind or (3) disabled.¹⁵ In order to qualify as a disabled individual, one must meet the Social Security definition of “disabled” (which applies to SSD and SSI alike): *The individual must be unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment that can be expected to result in death or has lasted or can be expected to last for a continuous period of at least 12 months.*¹⁶

If an individual is capable of earning an amount of monthly income which reaches or exceeds the Social Security definition of “Substantial Gainful Activity,” then that individual is presumed not to be disabled. Effective January 1, 2005, the Social Security definition of SGA was set at \$830 for a person who is not blind and \$1,380 for a blind individual. This definition will be indexed for inflation. For 2009, SGA is \$980 for a non-blind individual and \$1,640 for a blind individual.¹⁷

¹³ 20 C.F.R. § 416.110.

¹⁴ 42 U.S.C. § 1382f(a).

¹⁵ 42 U.S.C. § 1382c(a)(1)(A)

¹⁶ Social Security Act, § 216(i)(1) [42 U.S.C. 416]; 20 CFR § 416.905.

¹⁷ 69 Fed. Reg. 62497(12) (Oct 26, 2004).

(2) Residence Requirement

Must be a resident of one of the 50 states, or D.C. or the Northern Mariana Islands; Puerto Rico residents do not qualify. Absence for 30 consecutive days disqualifies the beneficiary from receiving benefits. The beneficiary cannot reacquire eligibility until having again resided in U.S. for 30 days. Non-citizens must meet “qualified” alien status. Illegal immigrants never meet this test.

(3) Income

There are 3 categories of income for SSI purposes. Income is either (1) countable or non-countable, (2) earned or unearned and (3) cash or in-kind support and maintenance (ISM).

“Income” is cash, or property that is readily convertible to cash, food or shelter. For 2009, the countable income limit for an unmarried person is \$674 and \$1,011 for a married couple. The first \$20 of income is not counted. A “gift” is defined as income.

“Earned Income” is defined as (1) gross wages as an employee without deductions for taxes or (2) net earnings from self-employment.¹⁸ Exclusions from “earned income” include (1) \$65 plus 50% of the remaining income; (2) \$10 of “infrequent income” (3) the first \$20 per month of most income and (4) certain federal assistance payments, such as food stamps, home energy assistance and housing assistance.¹⁹

“Unearned” Income” is defined as all income that is not otherwise defined by statute as “earned.” Unearned income includes annuities, pensions, alimony, support, dividends, life insurance proceeds, prizes, gifts and inheritances. Exclusions from “unearned income” include (1) the first \$20 per month of most income, (2) tuition scholarships and (3) 1/3 of child support payments received for the benefit of the disabled child. After applying the \$20 “disregard,” SSI cash benefits are reduced \$1 for each \$1 of unearned income received.

(4) In-kind Support and Maintenance

In-kind Support and Maintenance [ISM] is food or shelter furnished to the SSI recipient by a someone else.²⁰ Since SSI payments are intended to pay for the recipient’s food and shelter, similar benefits received from another source should reduce the amount of SSI payments payable for the month in which the outside benefits were received. This would be “unearned income” which would normally require the reduction of benefits \$1 for \$1. However, a special rule values the reduction of benefits for receipt of “in kind support and maintenance.” Application of the rule depends upon whether the SSI recipient resides in the home owned by another or whether he lives independently.

When the SSI recipient lives in the home of a third party (such as a parent or sibling), and the recipient does not pay *pro rata* share of all housing expenses, the reduction of the ISM from the monthly SSI check is 1/3 of the check, irrespective of the amount of ISM benefits received. This is called the “One-

¹⁸ 42 U.S.C. § 1382a(a).

¹⁹ 20 C.F.R. §§ 416.1112(b), (C)

²⁰ 20 C.F.R. § 416.1130

third Reduction Rule.” [For 2009 = \$674 divided by 3 = \$224.67; \$674 – 224.67 = \$449.33; Therefore, the amount of benefit for that month = \$449.33 + ISM provided].

When the SSI recipient lives in his own household, the value of the ISM is determined by application of the “Presumed Value Rule.” This rule reduces the monthly SSI check in the amount of 1/3 plus \$20.²¹ [For 2009 = \$674 / 3 = \$224.67 + \$20 = \$244.67; \$674 - \$244.67 = \$429.33; Therefore, the amount of benefit for that month = \$429.33 + ISM provided].

[Note: The accuracy of the examples above is subject to “rounding” determinations as published by the SSA].

In order to qualify as ISM, the payments for food and shelter must be made to 3rd party providers and not to the SSI recipient directly. Direct payments received will be classified as “unearned income” and will reduce benefits by \$1 or each \$1 received. Where is “clothing” in all of this discussion? A new 2005 SS rule eliminates “clothing” from the list of gifts.

(5) Deeming

SSI qualification is dependent upon “income” to a large degree. It is for individuals who have no other means of support. If other income is available, the SSI client may be disqualified. Income of another in the same household may be counted against the SSI client. This concept is called “deeming.” “Deeming” means that certain income or resources of an ineligible individual living in the household of the SSI recipient is considered as “available” to the recipient. Therefore, if an SSI recipient is living in the same household as an ineligible parent or spouse, income of the parent or spouse will be deemed to the SSI recipient. If a child under age 18 is living with his parent, the income of the parent is deemed to the child. The parent’s income is not deemed to the child after attaining age 18. The ineligible persons whose income may be deemed to the SSI recipient includes (1) parent, (2) spouse, (3) spouse of parent, (4) sponsor of an alien and (5) persons who are defined into one of those categories, such as a “live-in” arrangement where the ineligible individual may be considered as a “spouse” for deeming purposes.

(6) Resources

In addition to limited income, the SSI applicant must have a very low level of resources. Resources are defined as “cash or other liquid assets or any real or personal property that an individual (or spouse, if any) owns and could convert to cash to be used for his or her support and maintenance.”²² The SSI resource rules are similar to the Medicaid resource rules, but not exactly the same, since the states set some of their own rules under the Medicaid program.

The resource rules are (1) \$2,000 in countable resources for an individual; (2) \$3,000 in countable resources for a married couple; (3) a homestead, including all land attached; (4) a vehicle of any value; (5) household furnishings valued at less than \$2,000; (6) tools of trade or business; (7) burial plots for applicant

²¹ 20 C.F.R. § 416.1131

²² 20 C.F.R. § 426.1201(a)

and immediate family; (8) burial fund up to \$1,500; (9) life insurance with a face value of \$1,500 or less; and (10) one wedding ring and one engagement ring.²³

(7) Alternate Program Eligibility

The applicant cannot qualify for SSI without having applied for SSD. If the applicant qualifies for SSD and receives SSD income benefits which exceed the federal SSI rate, then the applicant is not eligible for SSI. If the applicant qualifies for SSD and receives a month income rate lower than the federal SSI rate, then the applicant can receive both SSD and SSI benefits (up to a maximum of the monthly SSI income rate), plus Medicare coverage (from SSD) and Medicaid coverage (from SSI).

(8) Non-institutionalization

The SSI applicant cannot receive SSI benefits while living in an institutional setting.

c. Transfer Penalties

Prior to 1999, transfers of resources could be made in order to qualify for SSI. This planning technique was eliminated with the passage of the Foster Care Independence Act of 1999. This act instituted transfer penalties for the SSI program for the first time. Transfers of resources for less than fair market value result in periods of ineligibility. The penalty is stated in the number of months that the applicant will not be eligible to receive benefits.

The calculation is computed by taking the amount of the transfer and dividing that amount by the maximum monthly benefit rate. For instance, a \$10,000 transfer would be calculated: $\$10,000 / 674 = 14$ month penalty. Whereas the Medicaid program has no maximum penalty period, the SSI program has a maximum penalty period of 36 months.

d. The SSI Model: "SSI" states" vs. "209(b)" states

For SSI purposes, states are categorized as either "SSI" states or "209(b)" states. In the majority of states (37), the "SSI" states, SSI recipients automatically receive health care coverage through Medicaid. A few states (13), called "209(b) states, have chosen to maintain their own rules for determining health care coverage as those rules existed before January 1, 1972.

e. The Program Operations Manual System (POMS)

The Social Security Program Operations Manual System (POMS) set out the rules that SSA workers use in dealing with SSI matters. Even though the POMS do not have force of law, the rules and procedures which comprise the POMS will be followed by the SSA irrespective of the law unless the practitioner can prove otherwise. The POMS are now available on the internet at www.ssa.gov.

f. Conclusion

²³ 20 C.F.R. § 416.1210.

Benefit programs for the elderly and disabled vary significantly, as do the tools which may be utilized to obtain eligibility. In order to properly advise an elderly or disabled client, the attorney must be thoroughly familiar with (1) the benefits available to the client; (2) the eligibility requirements for programs providing the benefits; (3) the tools which facilitate eligibility for the programs; and (4) the tax considerations when determining to implement a specific planning tool.

E. THE TRUSTS: CLASSIFICATION

Any discussion of trusts must first address the definition of a trust and then discuss the differences in the types of trusts with which the elder law practitioner must be familiar. As a general rule, every trust is either (1) revocable or irrevocable, (2) testamentary or inter vivos and (3) “self-settled” or “third-party.” The choice of trust depends upon the goals which the draftsman seeks to attain as limited by the laws which dictate specific parameters. For instance, the traditional living trust is “revocable” and “self-settled,” but it will not work as a special needs trust for a disabled individual. Once the attorney is familiar with the concepts defining the various types of trusts, it will be much easier to understand how each type of trust is utilized to address a particular need.

In his new estate and trust book, Professor Jeffrey Pennell, the estate planning guru from Emory University, provides the following definition: “Trusts are property management arrangements that bifurcate title between two parties, a fiduciary - the trustee - which holds legal title to the trust property for the benefit of one or more others - the beneficiaries - who hold the equitable or beneficial title to the trust property.”²⁴ The Social Security Administration’s *Program Operations Manual System* (POMS) states: “A trust is a property interest whereby property is held by an individual (trustee) subject to a fiduciary duty to use the property for the benefit of another (the beneficiary).”²⁵

In law school, we were taught that trusts are classified under multiple methodologies, depending upon the issue at hand. It is impossible to practice in this area of without a thorough understanding of which type of trust applies to the current circumstances being addressed. Implementing the wrong trust can result in adverse tax consequences, loss of creditor protection or denial of public benefits. This cannot be overstated. In his article entitled “Eligibility Rules of Supplemental Security Income (SSI) - 2003,” the outstanding SSI expert David Lillesand warns: “There are two ways to financially ruin an impoverished disabled person’s life: 1) to create the trust improperly...and 2) to manage the trust improperly...”²⁶

The most common classifications of trusts, including the characteristics of each, are outlined below:

1. Simple v. Complex

For income tax purposes, trusts commonly are divided into two groups: simple trusts and complex trusts.²⁷ These terms are not used in the IRS Code, but they are used in the Regulations.²⁸ The

²⁴ Pennell and Newman, *Estate and Trust Planning* (ABA 2006), at 219

²⁵ Social Security Administration Program Operations Manual System (POMS), SI 01120.200

²⁶ David J. Lillesand, “Eligibility Rules of Supplemental Security Income (SSI) - 2003” (Supplemental Needs Trusts V, Stetson University College of Law CLE, 2003). Emphasis supplied by author.

²⁷ Pennell, *supra*, at 478

generally accepted definition of a “simple trust” is one that must *require* that the trust (1) distribute all current income annually; (2) make no distributions for the year in excess of the amount of current income; and (3) make noncharitable distributions or set asides.²⁹ The generally accepted definition of a “complex trust” is any trust that does not qualify as a “simple trust” for that tax year.

For income tax purposes, a simple trust is a conduit, where the income is offset by the “distribution deduction” which results in no taxation at the trust level and all income being taxed to the beneficiary receiving the distribution.³⁰

For income tax purposes, a complex trust may accumulate income and may pay income tax at the trust level. The complex trust rules are found in Subpart C (§§661-664) and govern all estates and any trust which is not classified as simple trust.³¹

2. Revocable v. Irrevocable

A revocable trust may be revoked, modified or amended by the settlor as specifically set forth in the terms of the trust document. Any revocation, modification or amendment of a written trust must be accomplished through a written instrument. State law dictates the default classification of trusts which do not specifically define whether they are revocable or irrevocable. In Texas, for instance, all trusts are revocable unless the trust specifically states by “express terms of the instrument creating it” or “modifying it” that it is irrevocable.³² In some states, just the opposite is true.

3. Intervivos v. Testamentary

An “inter vivos trust” is a trust that is created and implemented during the lifetime of the settlor; i.e. a revocable living trust or an irrevocable life insurance trust.

A “testamentary trust” is a trust that is created in a Will and is implemented subsequent to the death of the settlor; i.e. a support trust for children created in the settlor’s Will.

For tax purposes, in inter vivos trust is activated when created and funded by the settlor. The testamentary trust is not activated as a taxable entity until assets are received by the trust upon distribution from the decedent’s probate estate or from a separate source.³³

4. Self-settled v. Third Party

²⁸ Id., at 478.

²⁹ Id., at 478.

³⁰ Id., at 480

³¹ Id., at 481

³² Texas Trust Code §112.051(C)

³³ Finn and Lavelle, *The Complete Trust Guide* (PESI 2006), at 1-1.

“Self-settled” trusts are trusts which are funded with the beneficiary’s own property. The “beneficiary” may, or may not, be the “settlor.” In the traditional living trust, the settlor is usually the beneficiary and funds the trust with his own property, which can be money, real estate or personalty. In contrast, the d4A special needs trust must be created by a parent, grand-parent, guardian or a court, but the property funded into the trust belongs to the beneficiary. An example would be a typical SSI case where an individual becomes totally incapacitated due to a medical mistake and a malpractice suit results in a substantial recovery. The money recovered belongs to the plaintiff individually. The facts situation calls for a special needs trust. The trust may be created by the court in which the suit is pending. Therefore, the court is the settlor. The trust is funded with the recovery from the law suit which would otherwise belong to the beneficiary. Therefore, the trust is “self-settled” because the money belonging to the beneficiary has been used to fund a trust for to benefit the owner of the assets conveyed into the trust

“Third-party” trusts are trusts which are funded with property of someone other than the beneficiary. An everyday example is a parent who leaves assets to his child in trust under the terms of the parent’s Will. In this case, the money belongs to the parent. The parent has no obligation to leave the property to the child. The parent chooses to create a trust under his Will. Therefore, the trust is (1) testamentary, (2) irrevocable and (3) third-party – funded with money belonging to the parent, not property belonging to the beneficiary.

Since this concept can be difficult to grasp, I suggest that the two questions below be applied to any trust in order to determine whether you are dealing with a self-settled trust or a third-party trust.

Q: Who owned the property immediately before funding?

A: If the property which is being used to fund the trust actually belonged to the beneficiary immediately before being transferred into the trust, it is “self-settled” trust. If the assets belonged to anyone other than the beneficiary immediately before funding, it is a third-party trust.

Q: Is the beneficiary “entitled” to the property?

A: Always determine whether or not the beneficiary is absolutely entitled to receive the property being conveyed into the trust. If so, it is a “self-settled” trust. If not, it is a “thirdparty” trust. For example, an inheritance is a gift, not an obligation. The beneficiary of an inheritance is receiving the bequest only because the owner chose to name the beneficiary in his Will. The beneficiary is not entitled to receive the property; it could have been given to anyone chosen by the testator. Therefore, the trust established in the testator’s Will is a third-party trust. If an individual receives a judgment in a law suit, it has been determined that the individual was entitled to receive the money. The defendant could not choose to give the money to someone else. Since the plaintiff is absolutely entitled to receive the money which is then placed in trust for his benefit, the trust is self-settled.

5. Grantor v. Non-Grantor

The determination of whether a trust is a grantor trust is primarily an income taxation function. When the trustee makes a distribution to a beneficiary, some of the distribution may consist of trust principal and some may be current income. The portion which will be subject to income tax is called “Distributable Net Income” or “DNI.” In dealing with the “Grantor Trust Rules,” we are determining who is going to be responsible for paying the income tax on the DNI distribution.

Under Subchapter J of the Internal Revenue Code (IRC), the general rule is that the grantor no longer has control of the assets once the trust is created and funded. From that point forward, distributions to the beneficiaries will result in current income being taxed to the individual receiving the taxable income. These trusts would be non-grantor trusts.

The Grantor Trust Rules are found in Subpart E (§§671 - 679) of Part I of Subchapter J of the IRC. A grantor trust is a trust under which the grantor or someone other than the grantor is treated as the “owner” of the trust assets for tax purposes, specifically income tax, under §§671 through 679 of the IRC.³⁴

When Subpart E applies, general principles of income taxation are supplanted by the grantor trust rules and the applicable portion of the trust is said to be “ignored” for income tax purposes. To the extent this occurs, income, losses, deductions, and credits allocable to that portion of the trust are attributed to the grantor rather than to the trust or its beneficiaries.³⁵

Through careful and proper use of the grantor trust rules, the grantor and the trust draftsman can determine at the time of implementation who will be responsible for paying the income tax generated by the trust in the future. This is usually done to allow the trust principal and current income to pass to the named beneficiaries while the grantor is responsible for payment of the taxes. This further depletes the grantor’s taxable estate and allows more of the grantor’s assets to pass to the beneficiaries without the burden of paying current income tax.

6. Court-created Trusts

Court-created trusts are usually based upon specific state statutes to allow proper management and protection of assets which would otherwise pass directly to an individual, but for a specific disability. The assets are generally proceeds from litigation. The beneficiary is usually either a minor individual or someone who is disabled under the definition of the Social Security Administration. The Court usually protects the interests of the incapacitated beneficiary by the appointment of a corporate trustee.

These trusts are usually created at the funding of a litigation proceeding, such as a personal injury lawsuit or a medical malpractice case, when the plaintiff is incapable of accepting or managing the recovery.

F. THE TRUSTS: QUALIFYING OR MAINTAINING PUBLIC BENEFITS

Elder law attorneys use trusts to assist the elderly and disabled in obtaining (qualifying) for public benefits or to maintain benefits for which they have already qualified. Public benefit programs are usually classified as either (1) means tested or (2) non-means tested.

1. “Means Tested” and “Non-Means Tested” Public Benefit Programs

³⁴ Myers and Bourland, “Grantor Trusts Including Grantor Retained Interest Trusts, Qualified Personal Residence Trusts and Intentionally Defective Grantor Trusts” (State Bar of Texas, 28th Adv. Estate Planning and Probate Course, 2004), at 1.

³⁵ Pennell, *supra*, at 490.

If a program is means tested, the applicant is limited as to the available resources attributable to him. Too many countable resources (assets) will disqualify the applicant from obtaining benefits from the program. For example, the traditional countable resource limit for an individual applying for SSI or Medicaid benefits is \$2,000. If the applicant has a \$10,000 certificate of deposit, he exceeds the countable resource limitation and will not qualify for the program.

If a program is non-means tested, there is no “resource test” applied to applicants and the amount of resources owned is irrelevant to qualification. For example, when an individual reaches age 65 and has paid into the system through payroll taxes as required, he can have \$1,000,000 in the bank and still receive Medicare benefits. If the same individual was injured on the job at age 55 and meets the requirements of the Social Security Disability program, he can receive cash payments and Medicare benefits even if he has \$500,000 in the bank. Qualification for non-means tested programs are based upon criteria other than how many resources the applicant owns.

Trusts are used to make assets which would otherwise be available to a beneficiary be classified as “unavailable.” Available resources will disqualify an applicant from receiving benefits of a means tested public benefit program. Alternatively, resources which are classified as “unavailable” will not disqualify the applicant. Ownership of resources is only applicable to means tested public benefit programs. Therefore, since trusts are used to limit available resources, it is not necessary to implement trusts in order to qualify for non means tested programs such as Medicare or SSD. Trusts are only relevant when dealing with the means tested programs such as Medicaid and SSI.

2. OBRA 93 and the exception trusts created

As a general rule, assets which are held in trust for a beneficiary are classified as “available” and are thus a “countable resource” of that individual. OBRA 93 defined both the general rule and established exceptions to that rule. The treatment of trusts as they apply to individuals seeking public benefits are defined in 42 U.S.C. 1396p(d). These provisions apply only to self-settled trusts.

a. 42 U.S.C. 1396p(d)(3)

42 U.S.C. 1396(d) is entitled: “Treatment of trust amounts.” Section 1396(d)(3) addresses both irrevocable trusts and irrevocable trusts. Sub-section (3)(A)(I) states that the corpus of a revocable trust shall be considered an available resource. Sub-section (3)(B) states that any portion of an irrevocable trust that could be distributed to an individual shall be considered an available resource. Under the provisions of 1396(d)(1) and (d)(2), these sections “shall apply to trusts established by such individual” to the extent that “assets of the individual were used to form all or part of the corpus of the trust...”

b. 42 U.S.C. 1396p(d)(4)

Under the general rules set out in 42 U.S.C. 1396(d), the trusts so frequently used in disability planning, such as the special needs trust or the Miller Trust, would be considered available resources to the beneficiary and would thus disqualify the applicant from receiving public benefits. However, certain trusts were exempted from these rules in 42. U.S.C. 1396p(d)(4). These trusts form the core of much of our SSI and Medicaid practice. They are the “under 65 disability / special needs trust” [(d)(4)(A)], the “qualified income / Miller trust” [(d)(4)(B)] and the “pooled trust” [(d)(4)(C)].

c. HCFA Transmittal 64

The Health Care Finance Administration (HCFA) was the predecessor to the Center for Medicare and Medicaid Services (CMS). This agency is responsible to administering certain public benefits programs, including interpretation of the laws that apply to program qualification on the federal level. HCFA

Transmittal 64 is a lengthy memorandum which detailed the regulations concerning the OBRA exception trusts. Section 3259 of HCFA Transmittal 64, entitled "Treatment of Trusts" is comprised of sub-sections 3259.1 through 3259.8. Sub-section 3259.7, entitled "Exceptions to Treatment of Trusts Under Trust Provisions" specifically addresses Special Needs Trusts, Pooled Trusts and Miller Trusts.

d. Other OBRA 93 and HCFA Transmittal 64 Trusts

In addition to the more well-known Special Needs Trust, Miller Trust and Pooled Trust specifically addressed in 42 U.S.C. 1396p(d)(4)(A), (d)(4)(B) and (d)(4)(C), there are two other trusts which have arisen under the provisions of the statute and the transmittal. The "Income Only Trust" is authorized by 42 U.S.C. 1396p(d)(3)(B). The "Sole Benefit Trust" is "a creature of HCFA Transmittal 64" as described by Tom Begley. The specific provisions are found in Section 3257. That section also created the "Disability Annuity Trust."

G. THE TRUSTS: TYPES OF TRUSTS.

1. Management and Support Trusts.

a. The Revocable Living Trust

The Revocable Living Trust is arguably the most popular trust used in the country today. It has gained notoriety as a probate avoidance and management planning tool. The living trust is not used as a disability planning trust. 42 U.S.C. 1396p(d)(3) states that revocable trust are always an available resource. This determination is repeated in HCFA Transmittal 64. Payments or contributions to the trust are not considered transfers because the settlor can always obtain distributions upon request. Distributions from the trust to third parties are considered transfers by the Settlor and are subject to penalty periods of ineligibility during a 60 month look-back.

The living trust is not to be used as an asset protection planning tool, since all assets held by the trust are available to satisfy creditor claims unless the assets are otherwise exempt from attachment.

Traditionally, living trusts are used to:

- (1) Avoid state probate in the jurisdiction of residence
- (2) Avoid ancillary probate in other state where real estate is owned
- (3) Manage assets of elderly or disabled individuals
- (4) Avoid Will contests (contesting a trust is usually more difficult)
- (5) Avoid having assets listed on a state inventory

While some elder law practitioners have implemented living trusts as an estate recovery avoidance planning tool, it is imperative that the attorney be familiar with his or her state's estate recovery laws. It is the position of CMS, as well as a number of individual states, that a residence which is held in a living trust is a countable resource.

Practitioners should be aware that thousands of elderly individuals own living trusts which do them more harm than good. These trusts have been – and are continuing to be – sold by “door-to-door” salesmen whose primary interest is to sell annuities to elderly individuals. The vast majority of these trusts are “cookie-cutter” trusts which have mandatory tax planning credit shelter trusts as the distribution plan. This is true irrespective of the estate value of the settlors. Very rarely will one of these trusts be properly funded, thus requiring a probate of the “pour-over Will” at the settlor's death. If title to the homestead passes to a credit shelter trust upon the death of the first settlor, title problems may be encountered when this directive is ignored and the survivor or children later attempt to sell the property. Any attorney recognizing this problem during the joint lifetimes of both settlors will be doing a service to the client – and should be well paid – by exposing this problem and either amending or revoking the trust.

It is also reprehensible that these trusts are marketed to the elderly, based upon lies concerning the cost of probate (lawyers are now prohibited from doing this, but most of these trusts are sold by non-lawyers). A Medicaid recipient cannot be the permissible beneficiary of a living trust. Therefore, when one spouse becomes disabled and needs nursing care, the living trust must usually be revoked, thus creating more expense and rendering the initial costs of the trust to have been wasted.

Lawyer Beware: One should always be familiar with current rules with planning for something as volatile as estate recovery. What may be a successful plan today may be changed tomorrow with little or no notice.

Practice Point: A living trust can save a substantial amount of money for clients who own real estate in multiple jurisdictions. Typically, the Will of the deceased spouse must be probated in the state of residence first. From that point forward, the executor must comply with the laws of each state in which the decedent owned real estate in an ancillary proceeding to have the decedent's ownership interest pass to the beneficiaries under the Will. If a living trust is established and all real estate in the various jurisdictions are properly conveyed into the trust under the laws of that state, all probates can be avoided.

A Myth Exposed: Many clients believe that assets which are transferred into a living trust are thereafter protected from creditor claims. The truth is that a living trust offers no asset protection whatsoever. Since the settler is able to move assets in and out of the trust at will, judgment creditors can reach the assets titled in the name of the living trust unless the asset has other inherent creditor exemption protections, e.g. the homestead.

b. Support Trusts

Support trusts are the most common type of trust. The traditional support trust is a third-party, irrevocable, testamentary, spendthrift, generation-skipping trust with an ascertainable standard. In other words, it is usually set up in the settlor's Will, to benefit the settlor's children and grandchildren, will become effective and irrevocable upon the settlor's death, appoints an independent trustee and is intended to be creditor protected by including a spendthrift clause and an ascertainable standard. Many testamentary support trusts are contingent. They will only become effective if the settlor dies prior to the beneficiary reaching a certain age, i.e. 21. If the beneficiary has reached the specified age at the date of the settlor's death, the gift will pass outright, and the trust will never be implemented. This technique is often used to guarantee that no guardianship will be required if the intended beneficiary is a minor. Support trusts are generally classified as traditional support trusts or discretionary support trusts.

(1) The Traditional Irrevocable Support Trust

The traditional irrevocable support trust is intended that the income and principal of the trust be utilized to support the beneficiary. The trustee's distribution standard states that the trustee "shall" make distributions for the beneficiary's "health, education, maintenance, or support." This standard requires distributions when these needs arise and give the beneficiary more leverage to judicially enforce their rights if the trustee is reluctant to make distributions which the beneficiary believes are reasonable and necessary.

(2) The Discretionary Support Trust

The discretionary support trust places more reliance upon the trustee's determination as to what is in the beneficiary's best interests. The trustee's distribution standard states that the trustee "may" (as opposed to "shall") make distributions for the beneficiary's "health, education, maintenance, or support." This standard gives the beneficiary less leverage to judicially enforce his rights to receive distributions from the trust.

(3) The "Descendant's Inheritance Trust"³⁶

The "Decedent's Inheritance Trust combines the best elements of support trust, asset protection, asset management and disability planning. If a client's estate warrants planning for their children's and grandchildren's potential asset protection needs, I always recommend this trust. It is the alternative to leaving assets outright upon the last parent's death. Any assets left directly to children will be subject to their creditor claims and may eventually fall under the "community presumption" which would subject them to division upon divorce.

The Inheritance Trust allows the responsible child or grandchild to act as their own trustee, subject to an ascertainable standard.³⁷ The trust remains in place for the full lifetime of the child and for the majority of the lifetime of the grandchildren. If desired, another family member or a corporate trustee can

³⁶ Randy Drewett, "The Decendant's Inheritance Trust" (2001), available at www.randydrewett.com

³⁷ See discussion re: *UTC*, § 504(e), at 42, *infra*.

be named. Although the beneficiary, in the role as trustee, can make distributions to himself, the trust assets never become community property and are protected from reach by the beneficiary's creditors.³⁸

If the beneficiary is disabled at the time the trust would otherwise come into being, alternate trust provisions can be added to become effective which would appoint an alternate trustee, eliminate the ascertainable standard and effectively convert the trust to a third-party purely discretionary trust.

(4) The Inter vivos Support Trust

While most support trusts are established to become effective at the time of the settlor's death, some settlors choose to establish the trust and begin funding during their lifetime. Using this type of trust, the settlor, along with the settlor's spouse and any other third party can make gifts to the trust. For taxable estates, the settlor can utilize individual or joint (for split gifts) annual gift tax exclusion gifts (currently \$13,000 per individual or \$26,000 per married couple) to decrease the size of the estate which might be subject to federal estate taxes.

(5) Asset Protection for Support Trusts

Irrespective of which type of support is utilized, the inclusion of a spendthrift provision and the ascertainable standard language is sufficient to protect the trust from being reached by creditors of the beneficiary.³⁹

(6) Medicaid Considerations for Support Trusts

The ultimate question for Medicaid purposes where trusts are concerned is whether or not the trust will be considered as an "available resource." State laws vary considerably on the criteria used to make this determination. This is especially a problem considering the speed with which Medicaid laws are changing in a direction adverse to the Medicaid applicant. The current Texas rule is that where the trust gives the trustee discretion in determining whether or not to make a distribution to the beneficiary, the trust is not an available resource to the client.

The better practice is not to use a support trust of any type if Medicaid is a potential factor in planning. The settlor should utilize a third-party purely discretionary trust (discussed below) which does not include an ascertainable standard of support, but which does include a spendthrift provision. The trust includes specific language which excludes any possibility of the beneficiary being able to reach trust assets or to demand any distribution for any purpose.

2. The Public Benefits Trusts

a. The Purely Discretionary Trust

³⁸ See discussion re: *Restatement of Trusts 3d*, at 41, *infra*.

³⁹ This is subject to controlling law in the beneficiary's jurisdiction with regard to rights given to "excluded creditors" for purposes such as child support or spousal support orders.

The purely discretionary trust is much like the third-party SNT except that there is no “supplemental needs” standard of distribution. Other than the issue of distributions, the rules recited above for third-party SNT’s apply to purely discretionary trusts.⁴⁰

(1) Distributions

- (a) The trustee is given absolute, complete discretion in making distributions from the trust for any reason.
- (b) The trustee is given the discretion to make no distributions whatsoever. This allows for supplemental needs distributions, ISM distributions or no distributions at all.
- (c) The discretion of the trustee is the focal point of drafting and should be stressed, defined and repeated. Obviously, the inability of the beneficiary to demand or access the trust property is imperative.

(2) Limitations

- (a) One must be familiar with state law regarding trusts and public benefits eligibility. Purely discretionary trusts are not effect for public benefits planning in Ohio based upon case law. It is possible that other states might follow this lead.
- (b) The Purely Discretionary Trust is accepted in Texas for Medicaid and SSI purposes. This trust is often the trust of choice by elder law and disability planning attorneys in Texas.

b. The Income Only Trust.⁴¹

There are several different trusts which are used to assist individuals to qualify for Medicaid benefits. The type of trust to be implemented must meet the client’s goals based on the client’s individual circumstances. The Income Only Trust is available for a client or couple who has made an informed decision that there are assets on hand which are not necessary to maintain the client’s lifestyle, but the children do not invoke enough confidence to warrant outright gifts of those assets. The client must be relatively healthy in light of the 60 month look-back involved in this gift.

(1) Purpose

- (a) To allow a client or couple to gift assets into a trust which divests the settlor of any interest in the corpus, but provides an income stream to be paid to the settlor.
- (b) This gift eliminates the assets transferred to the trust from the countable resources of the client for Medicaid purposes after the expiration of the 60 month look-back period.

⁴⁰ “Discretionary Trusts” are currently the subject of much discussion in the area of trust law. *UTC* § 504 entitled “Discretionary Trusts; Effect of Standard” is intended to “eliminate the distinction between discretionary trusts and support trusts,” according to the official commentary.

⁴¹ 42 U.S.C. 1396p(d)(3)(B)

(2) Authority

- (a) The “Income Only Trust” is authorized under 42 U.S.C. 1396p(d)(3)(B).
- (b) While the statutory language is neither comprehensive nor clear, additional official documentation and commentary has evolved since OBRA 93 to clarify how this trust is to structured and administered. Much of the focus is upon a letter dated December 23, 1993 from Sally K. Richardson (of HCFA) to Elice Fatoullah (Alzheimer’s Association - New York) which confirms the treatment of transfers to a trust from which the settlor may not ever be allowed distributions of principal.
- (c) In his book, *Third-Party and Self-Created Trusts*, Clifton Kruse, Jr. refers to these trusts as “self-created income-stream trusts” and gives an excellent discussion on pages 8-10.⁴²

(3) Requirements

- (a) The trust must be irrevocable.
- (b) The trust must prohibit distributions of corpus to the settlor or the settlor’s spouse.
- (c) The trustee should be authorized to make distributions to third parties.
- (d) The trustee should be given discretion as to when income distributions will be made to the settlor.

(4) Advantages

- (a) The income only trust is generally used by individuals who wish to make transfers of assets for advanced Medicaid planning, but do not want to give the money directly to their children.
- (b) By placing the assets in this irrevocable trust, the settlor can allow himself the benefit of receiving distributions of income in the future and having the assets managed by a trustee of his choosing.
- (c) The settlor can name remainder beneficiaries and may give a special power of appointment for future distributions. This type of trust can be used to avoid probate and even potentially avoid estate recovery.

(5) Disadvantages

- (a) Transfers to an income only trust result in a penalty being assessed with a 60-month look-back period. Pursuant to the statutes involved, any amounts of principal that could possibly be distributed to the settlor will be considered as an available resource.

⁴² Kruse, Clifton, *Third-Party and Self-Created Trusts*, 3d Ed. (ABA 2002), at 8-10.

- (b) Assets conveyed to this trust will not receive a “step up” in tax basis when ultimately distributed to the settlor’s remainder beneficiaries, as opposed to the step up which results from an inheritance at death.

c. The SNT: The “Under 65 Pay-back Special Needs Trust”⁴³

The most widely publicized disability trust is the Special Needs Trust. This trust is called by various names: (1) Special Needs Trust; (2) Supplemental Needs Trust; (3) Under 65 Disability Trust; (4) d4A Trust; (5) Pay-back Trust, and most commonly, (6) the SNT. Due to the fact that there is a separate and distinct Third-Party Special Needs Trust, I refer to this trust as the d4A trust.

(1) Authority

- (a) The d4A trust is the first specific exception trust authorized by OBRA 93 in U.S.C. 1396p(d)(4)(A). It is self-settled and is funded with assets of the beneficiary, usually litigation proceeds.
- (b) If properly drafted and administered, funding of the trust will not be considered a transfer and the corpus of the trust will not be considered “available” to the beneficiary.

(2) Requirements

- (a) The trust must be established by a parent, grandparent, guardian or a court. It cannot be established by the beneficiary. Many states have court-created statutory trusts which can be established in the guardianship courts.
- (b) The beneficiary must be under age 65 when the trust is created. The trust can continue after attaining age 65, but no further contributions to the trust may be made without incurring a transfer penalty. There is an exception to the contribution rule for continuing payments from a structured settlement that began prior to age 65.
- (c) The trust must be irrevocable.
- (d) The statute requires that the SNT must contain a “pay-back” provision directing the trustee to pay all trust proceeds to the state Medicaid authority upon the death of the beneficiary to the extent that Medicaid benefits were paid on behalf of the beneficiary during his lifetime. This pay-back provision is only required for the d4A SNT and not for a Third-Party SNT.

(3) Distributions

- (a) The trust must be drafted and administered solely for the benefit of the disabled individual. Distributions are not considered to be “income” to the beneficiary. Traditionally, the trustee will be authorized to make payment directly to third-party

⁴³ 42 U.S.C. 1396p(d)(4)(A)

vendors who provide non-support benefits. Non-support distributions do not reduce benefits.

- (b) If payments are made to a third-party who provides food or shelter to the beneficiary, these are considered “in-kind support and maintenance” or ISM. ISM will decrease the cash benefits paid to the beneficiary up to one-third if he is living with someone else, or up to one-third plus \$20 if he is living alone.

(4) Remainder Beneficiaries

- (a) The trust will generally provide for remainder beneficiaries for final distribution after the death of the disabled individual.
- (b) Any such distributions must be made subject to the required payback provision which must be satisfied prior to any other distributions to beneficiaries. Under this payback provision, the applicable state agency in charge of Medicaid administration must be named as primary beneficiary and must be reimbursed to the extent that Medicaid payments were made on behalf of the beneficiary.
- (c) Some state statutes require that the remainder of a court-created SNT, after satisfying the pay-back, be distributed to the personal representative of the deceased beneficiary’s estate.

d. The SNT: The Third-Party Special Needs Trust

The third-party SNT is not based upon OBRA 93 or the resulting statutes discussed above. This trust is not limited by statute with regard to creation, funding or age of beneficiary. If properly drafted, the corpus is never an available resource.

(1) Purposes

- (a) This trust should be used in estate planning situations where the testator or settlor wants to benefit a disabled individual who is receiving, or may in the future receive, public benefits which are means-tested.
- (b) The settlor can establish this trust either as an inter vivos “stand alone” trust or it can be a testamentary trust set out in the settlor’s Will or Revocable Living Trust.

(2) Requirements

- (a) The trust may be established by anyone other than the beneficiary.
- (b) The property funded into the trust may come from any source except from the assets belonging to the beneficiary.
- (c) The beneficiary can be of any age.
- (d) The trustee can be anyone other than the beneficiary.

- (e) There is no requirement that the trust contain a “pay-back” provision. Conversely, it is malpractice for an attorney to include a pay-back provision in a third-party trust. Since the terms of the trust control, there have been cases where money was paid to the state in repayment of Medicaid benefits provided when such repayment was not required. The remainder should have passed to the remaindermen.

(3) Distributions

- (a) Distribution language will depend on the draftsman. Third-party SNT’s can either be strict SNT’s or flexible SNT’s.
- (b) In the past, many of these trusts contained “supplemental needs only” distribution language which prohibited distributions for support needs.
- (c) More recently, SSI experts consider this to be too restrictive and unnecessary. The other two alternatives are to remain silent as to support distribution language or to discuss support distributions in the context of ISM, the Presumed Value Rule and the One-Third Reduction Rule, as discussed above.
- (d) One of the nation’s foremost SSI experts, David J. Lillesand, strongly suggests that it is in the beneficiary’s best interests to have flexible distribution language in third-party disability trusts that would allow the trustee to take advantage of the ISM rules.
- (e) Irrespective of how the distribution language is written, the corpus must not be available to the beneficiary. The language of the trust should stress the discretion of the trustee in making distribution decisions.

(4) Remaindermen

- (a) The state is not a remainder beneficiary of the trust.
- (b) Anyone else may be chosen to receive the net remainder of the trust.

e. The Miller Trust ⁴⁴

The Miller Trust is an income trust used exclusively in “income cap” states. States are permitted to select from approved methodologies for limiting the income of Medicaid applicants. Texas is an “income cap state.” This trust is specific exception trust endorsed by OBRA 93.

(1) Purposes

- (a) A minority of states select an income cap which does not exceed 300% of the current SSI cash benefit level. For 2009, this amount is \$2,022 based on the SSI benefit maximum of \$674 per month. States which do not utilized an “income cap”

⁴⁴ 42 U.S.C. 1396p(d)(4)(B).

are classified as “medically needy” states. Miller Trusts cannot be used in states with a “medically needy” program.

- (b) In income cap states, an individual with income exceeding the cap amount is ineligible to receive Medicaid benefits, irrespective of their resource level. In order to reduce countable income to an amount below the cap, certain defined income items may be assigned to an irrevocable trust.

(2) Authority

- (a) The 1990 Colorado case of *Miller v. Ibarra*, 746 F. Supp. 19 (D. Colo. 1990) established this procedure.
- (b) The Miller Trust was then codified by OBRA 93 in 42 U.S.C. 1396p(d)(4)(B).
- (c) The regulations are set out in HCFA Transmittal 64 at Section 3259.7(C).

(3) Creation and Funding

- (a) Since income for Medicaid purposes is limited to “the name on the check” rule, the only income items which may be deposited into the trust account are Social Security checks and pension checks payable to the Medicaid applicant.
- (b) Contrary to popular believe among the general populace, assets of the disabled applicant cannot be funded into the Miller Trust to “protect” them for Medicaid purposes.

(4) Distributions

- (a) Payment for the beneficiary’s personal needs allowance;
- (b) Payment for medical insurance, such as the beneficiary’s Medicare Supplement Policy;
- (c) Medical expenses;
- (d) Any approved spousal diversion amount; and
- (e) Payment to a nursing facility or CBA waiver program payment.

Practice Note: It is important to understand that distributions from the trust must be paid out in the same month as the income is received and to plan the administration accordingly. As a practical matter, the attorney should provide the client with an understandable checklist of procedures. If the client, who generally acts as the trustee, fails to make distributions in a timely manner, the beneficiary may lose Medicaid benefits for a month.

(5) Pay-Back Provision

- (a) The trust must contain a Medicaid pay-back provision. Any distributions to remainder beneficiaries upon the death of the disabled lifetime beneficiary must be made subject to the required pay-back provision which must be satisfied prior to any other distributions to beneficiaries.
- (b) Under this payback provision, the applicable state agency in charge of Medicaid administration must be named as primary beneficiary and must be reimbursed to the extent that Medicaid payments were made on behalf of the beneficiary.

f. The Pooled Trust ⁴⁵

The third OBRA 93 statutory trust is the pooled trust.

(1) Authority / Purposes

- (a) This trust is specifically established at 42 U.S.C. 1396p(d)(4)(C) and HCFA Transmittal 64 at Section 3259.7(B).

(2) Requirements

- (a) The pooled trust must be established and managed by a non-profit organization.
- (b) The beneficiary may be older than age 65 at the time of the creation of their pooled trust account.
- (c) Transfers into the pooled trust are not subject to transfer penalties.
- (d) The pooled trust is generally one trust written on behalf of the nonprofit sponsor. Each applicant is not required to have his own trust document. Accordingly, drafting is not a problem or expense. The applicant is only required to have a “joinder agreement” to be admitted into the pool. Each individual beneficiary has his own sub-account created for accounting purposes.

(3) Investments / Administration

- (a) The applicant’s individual funds are pooled together with assets of other pool members for investment and management purposes. This usually results in much better investment returns than an individual would expect to receive on their small amount of assets.
- (b) It is often difficult to find an appropriate trustee to manage a traditional Special Needs Trust. Most corporate trust departments require large sums of trust corpus before accepting the trusteeship and charge fees that many regard as expensive. The pooled trust is an excellent choice for applicants with smaller amount of assets

⁴⁵ 42 U.S.C. 1396p(d)(4)(C).

which would otherwise disqualify them from receiving benefits. A corporate trustee selected by the sponsor acts as trustee. No independent trustee is required.

- (c) Many pooled trusts accept accounts established with third-party money, such as inheritances, as well as traditional self-settled accounts.

(4) Pay-Back Provisions

- (a) A sub-account funded with money belonging to the applicant (self-settled) requires a pay-back provision.
- (b) Sub-accounts funded with third-party contributions such as gifts and inheritances do not require a pay-back provision.

3. Court-created Trusts

Court-created trusts are usually based upon specific state statutes to allow proper management and protection of assets which would otherwise pass directly to an individual, but for a specific disability. The assets are generally proceeds from litigation. The beneficiary is usually either a minor individual or someone who is disabled under the definition of the Social Security Administration. The Court usually protects the interests of the incapacitated beneficiary by the appointment of a corporate trustee. These trusts are usually created at the funding of a litigation proceeding, such as a personal injury lawsuit or a medical malpractice case, when the plaintiff is incapable of accepting or managing the recovery.

H. THE TRUSTS: FINAL COMMENTS

1. Specific Applications of Trust Law

a. Rights of revocation and ability to direct distribution

The POMS states that trust assets will be treated as “available” if the beneficiary has the right to revoke the trust. In most third-party trusts, the settlor, the beneficiary and the remaindermen are different individuals. The remainder beneficiaries take only upon the death of the primary beneficiary and the beneficiary has no power to revoke the trust. POMS S.I. 011200.200.D.1.b. states:

“A beneficiary generally does not have the power to revoke a trust. However, the trust may be a resource of the beneficiary, in the rare instance, where he/she has the authority under the trust to direct the use of the trust principal. (The authority to control the trust principal may be either specific trust provisions allowing the beneficiary to act on his/her own or by ordering actions by the trustee). In such case, the beneficiary’s equitable ownership in the trust principal and his/her ability to use it for support and maintenance means it is a resource.”

An additional problem is how Social Security treats the failure of the trust to name a remainder beneficiary. Under those circumstances, SS takes the position that the lifetime beneficiary has the right to revoke the trust.

b. Doctrine of Worthier Title

Since Social Security looks to state law in determining whether or not the beneficiary has the right to revoke the trust, two issues can create a problem. If the trust (1) fails to name a remainder beneficiary or if the trust states that the remaining trust assets will (2) pass under intestacy to the “heirs-at law” or “next of kin” Social Security may take the position that the trust is revocable. The Doctrine of Worthier Title says that if a trust names on the heirs or next of kin as remaindermen, or refers to intestacy statutes as determinative, then under those circumstances, the lifetime beneficiary has the right to revoke the trust. Such a determination would make the trust an available resource.

c. Availability

The POMS look to (1) whether a trust is revocable or to (2) whether the beneficiary has the right to direct distributions of trust assets for his or her support needs in determining if the trust corpus is an available resource. Specific terms of the trust should clearly state that the trust is irrevocable and that the beneficiary has no right to direct the trustee to distribute trust assets to or for the use of the beneficiary to satisfy support needs.

d. With regard to distributions of trust income, the POMS state:

- (1) “If the trust principal is not a resource, disbursements from the trust may be income to the SSI recipient beneficiary, depending on the nature of the disbursements. Regular rules determine when income is available apply.”
- (2) “Cash paid directly from the trust to an individual is unearned income.” Therefore, it is crucial for the trustee of a special needs trust to have a clear understanding of the SSI income rules and to limit distributions to those expenditures which are appropriate.
- (3) “Disbursements from the trust by the trustee to a third party that result in the individual receiving items that are not food or shelter are not income.”

I. ASSET PROTECTION ISSUES INVOLVING TRUSTS

With the erosion of creditor protection in historically bullet-proof trusts, it has become imperative to remain current with the law and national trends involving the creation and administration of trusts. Some practitioners chose to utilize the laws of other states to take advantage of the repeal of the rule against perpetuities or to take a shot at first-party creditor protection with a “Domestic Asset Protection Trust.” In this regard, it is important to understand the general principles, as well as the current issues and attacks upon “spendthrift trusts” and the “ascertainable standard.” Additionally, issues such as “beneficiary as trustee” and “exemption creditors” are discussed regularly in trust literature.

Finally, one should be familiar with the on-going debate over Article Five of the *Uniform Trust Code* (“UTC”) which has been adopted in several states with consideration in numerous others.⁴⁶ Although the current attack on traditionally creditor protected trusts involves a combination of these doctrines and related issues, we will take them individually for purposes of discussion.

⁴⁶ As of the Summer of 2006, the UTC had been adopted in 19 jurisdictions, including Alabama, Arkansas, the District of Columbia, Florida, Kansas, Maine, Missouri, Nebraska, New Hampshire, New Mexico, Missouri, North Carolina, Ohio, Oregon, South Carolina, Tennessee, Utah, Virginia and Wyoming. Legislative or bar association consideration is being given to adoption in Massachusetts, Pennsylvania, Colorado, Connecticut, Georgia, Idaho, Michigan, Montana and Washington.

1. The “Spendthrift” Trust

At common law, by Restatement⁴⁷ and as codified in various trust statutes, settlors have been allowed to invoke “spendthrift” protection for the benefit of third-party beneficiaries. A spendthrift trust is one “that provides by its terms that the interest of a beneficiary in the income or principal of the trust may not be voluntarily or involuntarily transferred to otherwise alienated by the beneficiary, except as provided by the trust instrument.”⁴⁸

The mere inclusion of spendthrift protection does not guarantee the benefits quoted above. For instance, the Fifth Circuit has held that “a settlor cannot create a spendthrift trust for his own benefit and have the trust insulated from the rights of creditors.”⁴⁹ With regard to third-party beneficiaries, however, Texas courts have long recognized that a settlor “has a right to devote [her] own property to promote and secure the welfare and comfort of [the beneficiary] and to protect [the beneficiary] against the vicissitudes of fortune.”⁵⁰ The right to establish a spendthrift trust has been approved by the Restatement of Trusts 2d since 1959.⁵¹ Unfortunately, recent trends have seemed to empower some courts to ignore spendthrift protection by allowing certain creditors to reach the assets of a traditional spendthrift trust.⁵² The problems appear to have their roots in the *Restatement 3d* and the *UTC*, discussed in more detail below.

Some states take a position contrary to that of the Restatement. In Texas, for example, the Texas Trust Code section entitled “Spendthrift Trusts” was amended in 2006⁵³ by the addition of subsection (f), which clarifies that a beneficiary cannot be considered as a “settlor” of the trust merely because he has the power to (among others) distribute property to himself, or for his benefit, as long as that power is limited by an ascertainable standard.⁵⁴ This is the opposite view to *Restatement 3d*, §60. .

2. The “Ascertainable Standard”

The “ascertainable standard” is created by the inclusion of those magical words “health, education, maintenance or support.” This standard has been used by estate planners for years to exclude assets of such a trust from being taxed in the beneficiary’s estate. It has also been used in irrevocable support trusts to define that trust as a third-party creditor protected trust.

The importance of including the ascertainable standard in spendthrift trusts cannot be overstated. In his discussion of cases where the courts have allowed creditor infringement, the cases discussed by Mr.

⁴⁷ Mario A. Mata, “Increasing Creditor and Divorce Court Attacks on Spenthrift Trusts” (Wills, Probate and Elder Law Institute - University of Houston Law Foundation, 2006), at 3.

⁴⁸ Mata, *supra*, at 3.

⁴⁹ *Id.*; *Matter of Shurley*, 115 F.3d at 337 (5 Cir 1997).

⁵⁰ *Adams v. Williams*, 248 S.W. 673 (Tex. Comm. App. 1923).

⁵¹ Restatement of the Law, 2d, Trusts (American Law Institute 1959), at § 152.

⁵² The problems appear to have their roots in the Restatement of Trusts 3 d (2003) and the *Uniform Trust Code* (see sub-parts C, D).

⁵³ Texas Trust Code, § 112.035(f).

⁵⁴ *Id.* at § 112.035(f)(1)(A)(ii).

Mata involved trusts which either had no ascertainable standard or improperly attempted to include such a standard by deviating from acceptable language.⁵⁵

Practice Tip: The magic words to create an ascertainable standard are “health, Education, Maintenance or Support.” It is often referred to as the HEMS standard. You can drop a word if it is not potentially relevant. “Education” is often omitted. But do not add words or the entire standard may be disallowed and you can lose the protection you are seeking.

It is imperative for the third-party creditor protected trust to include a spendthrift clause and a pure ascertainable standard. Attempts at adding other words to the standard such as “care,” “comfort” or “happiness,” or specifically “required or desired” as in one case, will go a long way toward defeating the “desired” goal of creditor protection.⁵⁶

3. *Restatement of Trusts 3d*

The *Restatement of Trusts 2d* was adopted in 1959. The *Restatement of Trusts 3d*, issued in 2003, includes a significant departure from historical protections. While § 58 recognizes the validity of “spendthrift trusts,” the creditor protection afforded is subject to § 59, which specifically allows the trust to be reached to satisfy (a) a claim for child support, a claim for support by a spouse or claim for support by a former spouse or (b) a creditor who has supplied “services or supplies provided for necessities” or “for the protection of the beneficiary’s interest in the trust.” The new § 60 states that “if the terms of a trust provide for a beneficiary to receive distributions in the trustee’s discretion, a transferee or creditor of the beneficiary is entitled to receive or attach any distributions the trustee makes or is required to make in the exercise of that discretion after the trustee has knowledge of the transfer or attachment.” The implementation of such law might seriously bring into question the validity of the “Purely Discretionary Trusts” used by elder law attorneys in public benefits planning. Although the Restatement does not carry the force of law, it is an indication of nation trends and reflects what the Restatement believes the laws across the country to be. Not only is this an ominous sign in granting creditors rights that have been historically denied to them, but the *Restatement 3d* has joined in philosophy with the *UTC* to move the scale in favor of creditors.

4. *Uniform Trust Code*, Article Five

The *Uniform Trust Code* is meant to be the first national codification of the law of trusts.⁵⁷ The *UTC* was first drafted in 2000 and amended in 2002 and 2005. The *UTC* has been extremely controversial. In Arizona, for instance, the *UTC* was adopted in 2003. Immediately following enactment, a group of attorneys initiated a campaign to have the law repealed. The legislature repealed the law in 2004 without it ever having become effective.⁵⁸ As in other areas of law, emotions run high between those who believe that trust assets deserve to be protected and those who are aligned with creditors. One of the vocal proponents of creditor protection is Mark Merric, an attorney specializing in asset protection, who has

⁵⁵ Mata, *supra*, at 8-9.

⁵⁶ *Id.* at 8.

⁵⁷ *Id.*, at 11.

⁵⁸ Robert T. Danforth, “Article Five of the UTC and the Future of Creditors’ Rights in Trusts” (2005), at 18.

authored numerous articles on the subject of *UTC* Article Five.⁵⁹ On the other side, those on the other side speak in terms quite derogatory, referring to opponents as “a small, vocal group of critics” and “a small segment of the estate planning bar, most of whom apparently focus their practice on so-called asset protection.”⁶⁰

At the heart of the controversy is Article Five of the *UTC* entitled “Creditor’s Claims: Spendthrift and Discretionary Trusts.” While §502 recognizes the spendthrift trust, § 503 immediately following, entitled “Exceptions to Spendthrift Provisions” begins to define “exception creditors” who will be allowed to reach trust assets. In §504, entitled “Discretionary Trusts; Effect of Standard,” the *UTC* eliminated the distinction between discretionary trusts and support trusts. Irrespective of the existence of an ascertainable standard, the “exception creditors” are allowed to require distributions from the trust. Opponents of the *UTC* argue that the language and obvious intent of *UTC* Article Five will encourage courts and legislatures to expand the class of “exemption creditors” at will.

Of additional serious concern should be the fact that the *UTC* is supplemented by common law (*UTC* §106) and since the two seem to work in concert, and in light of the constant amendments to the *UTC*, practitioners should be aware that if taken together, all assets of a third party discretionary trust may be reachable by creditors if the beneficiary of the trust is also serving as trustee. Currently, inclusion of an ascertainable standard should prevent such an intrusion.

However, close attention should be paid to the drafting of third party discretionary trusts which allow the beneficiary to serve as trustee, but which do not limit distributions based upon the ascertainable standard. It appears that such trusts may be at considerable risk in *UTC* states.⁶¹

5. Current *UTC* Articles

Attorneys whose practice includes the drafting such trusts should become familiar with the resources quoted above. Among the articles which discuss the author’s position either “for” or “against” the *UTC*, the following papers will acquaint the reader with issues involved in the controversy (listed in chronological order from most recent):

Mark Cohen, Esq., “The Top Fourteen Things You Need to Know About the Uniform Trust Code,” 2 *NAELA Journal* 259 (2006).

Robert T. Danforth, “Article Five of the UTC and the Future of Creditors’ Rights in Trusts” 27 *Cardozo Law Review* 2551 (2006).

John K. Eason, “Policy, Logic, and Persuasion in the Evolving Realm of Trust Asset Protection” 27 *Cardozo Law Review* 2621 (2006).

⁵⁹ Mark Merric & Steven J. Oshins, “Effect of the UTC on the Asset Protection of Spendthrift Trusts,” 31 *Est. Plan.* 375 (2004); Merric & Oshins, “UTC May Reduce the Asset Protection of Non-self-settled Trusts,” 31 *Est. Plan.* 411 (2004); Merric & Stein, “A Threat to All SNTs,” *Tr. & Est.*, Nov. 2004, at 38.

⁶⁰ Danforth, *supra*, at 4.

⁶¹ I. Mark Cohen, Esq., “The Top Fourteen Things You Need to Know About the Uniform Trust Code,” 2 *NAELA Journal* 259, 278

Mario A. Mata, “Increasing Creditor and Divorce Court Attacks on Spendthrift Trusts” (University of Houston, *Wills, Probate and Elder Law Institute* 2006).

Jeffrey A. Schoemblum, “In Search of a Unifying Principle for Article V of the Uniform Trust Code: A Response to Professor Danforth” *27 Cardozo Law Review* 2609 (2006).

Mark Merric, “Problems in Uniform Trust Code States with SNTs” *NAELA Advanced Elder Law Institute* (Nov. 2006).

Mark W. Worthington, LL.M., CELA, “Will the Uniform Trust Code Negatively Affect a Third Party’s SNT?” *NAELA Advanced Elder Law Institute* (Nov. 2006).

Richard E. Davis CELA and Stanley C. Kent, “The Impact of the Uniform Trust Code on Special Needs Trusts” *1 NAELA Journal* 235 (2005).

Mark Merric, “The UTC: A Continuing Threat to Estate Planning” *31 Estate Planning Review* 1 (2005).

Alan Newman, “Creditors’ Rights Under the Uniform Trust Code” *39 Annual Heckerling Institute on Estate Planning* (2005).

David M. English, “The Uniform Trust Code (2000)” *39 Annual Heckerling Institute on Estate Planning* (2005).

Mark Merric, Douglas Stein, Carl Stevens, Eric Solem, Wayne Stewart and Mark Osborne, “The Uniform Trust Code: Part II - The Creation of an Enforceable Right in Almost All Discretionary Trusts” *CCH Journal of Practical Estate Planning*, (Dec. 2005-Jan. 2006).

Mark Merric, Douglas Stein, Carl Stevens, Eric Solem, Wayne Stewart and Mark Osborne, “The Uniform Trust Code: Part I - A Continuing Threat to SNTs Even After Amendment” *CCH Journal of Practical Estate Planning*, (April-May 2005).

Mark Merric and Steven J. Oshins, “Effect of the UTC on Asset Protection of Spendthrift Trusts” *Estate Planning* (In Three Parts: Vol. 31 at 375 August 2004; Vol. 31 at 411 September 2004; Vol. 31 at 478 October 2004).

Mark Merric and Douglas W. Stein, “A Threat to All SNTs” *Trusts and Estates* (Nov. 2004), at 38.

J. TAXES

1. Estate Taxes

The federal estate tax exemption amounts under current law are as follows:

2005	\$1,500,000
2006	\$2,000,000
2007	\$2,000,000
2008	\$2,000,000
2009	\$3,500,000
2010	Estate Tax Repealed

2011 \$1,000,000

The filing of an estate tax return is due within 9 months from the date of death. An automatic 6 month extension is available. All tax due must be paid within 9 months of death.

If there is a large value in a special needs trust, the estate tax is due upon the death of the beneficiary as discussed above. When settling a lawsuit with a structured settlement, annuities are often used. If the annuity cannot be commuted (cashed) at death, there may not be enough liquidity to pay the estate taxes.

2. Income Taxation of Trusts

For income tax purposes, trusts are classified as “simple” or “complex.”

A simple trust is one whose terms *require* that the trust (1) must distribute all current income annually; (2) must make no distributions for the year in excess of the amount of current income; and (3) may make no charitable distributions or set asides.⁶²

A “complex” trust is allowed to accumulate income. Income which is distributed is taxed to the beneficiary to the extent of Distributable Net Income (DNI). Income not distributed is taxed at the trust rates. Trust rates are more compressed than individual rates.

3. The capital gain exclusion for sale of homestead

Prior to 1997 there was a one-time \$125,000 exclusion on the reporting of gain on the sale of a homestead. The current law is found in IRC Section 121, as follows:

- a. Taxpayer can claim up to \$250,000 exclusion on the sale of the homestead if single or \$500,000 if married and filing jointly.
- b. The home must have been utilized as the primary homestead for 24 months out of the preceding 60 months prior to the sale.
- c. The exclusion can be used no more than once every 2 years, but there is no limitation on how many times the exclusion may be used.

4. Tax Treatment of Long-Term Health Care Insurance

Payment of premiums on a long-term care insurance policy may be deductible under certain circumstances, as follows:

- a. This is part of the medical expense deduction which is subject to the 7.5 percent adjusted gross income floor. Medical expenses cannot be deducted unless they exceed 7.5 percent of

⁶² Pennell and Newman, *supra*. at 478; Treas. Reg. §§1.651(a)-1(b). “The tax consequence of qualification as a simple trust to beneficiaries entitled to receive required distributions of income is §652(a) inclusion in income of the amount allowed as a deduction to the trust, whether the income actually was distributed or only required to be distributed.” For a more detailed discussion, see Chapter 20 of that book entitled “Income Taxation of Estates, Trusts, Grantors and Beneficiaries.”

adjusted gross income.

- b. This law became effective as part of the Health Insurance Portability and Accounting Act of 1996 (HIPAA). [See IRS Publication 502]

The deductibility of long-term health care insurance premiums is limited, based upon age (for tax year 2009):

40 or under	\$320
41-50	\$600
51-60	\$1,190
61-60	\$3,180
71 or older	\$3,980

In order to receive this benefit, the policy must be classified as “qualified.” The policy must have been issued on or after January 1, 1997 and must adhere to regulations established by the National Association of Insurance Commissioners.⁶³

⁶³ For more detailed information on deductibility of long-term care premiums, see “Long Term Health Insurance” *Elder Law Answers* (1/4/2009).