

## THE ANATOMY OF A THIRD-PARTY SPECIAL NEEDS TRUST

“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...”<sup>1</sup>

– David J. Lillesand, Esq.<sup>2</sup>

### 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) all relevant considerations necessary to determine which specific planning tool should be implemented to achieve or maintain the desired public benefits goal. 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) public benefit programs which may be attained or maintained by proper use of trusts; (2) the difference between “means tested” and “non-means tested” programs; (3) the difference between self-settled and third-party trusts; (4) specific issues which should be considered when drafting a Third-Party Special Needs Trust; (5) current Texas law which applies to the treatment of distributions from Third-Party Special Needs Trusts for public benefits treatment; and (6) national trends which affect or may affect the classification of trusts in the public benefits arena.

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, new laws regarding “income first,” estate recovery and overhaul of transfer rules under the Deficit Reduction Act of 2005 have been well documented and

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<sup>1</sup> David J. Lillesand, “Special Needs Trust Eligibility Rules - 2006” (Supplemental Needs Trusts VIII, Stetson University College of Law CLE, 2006). Emphasis supplied current author.

<sup>2</sup> David J. Lillesand is one of the nation’s leading authorities on Supplemental Security Income (SSI) and Special Needs Trusts. He appears each fall as a speaker for the Stetson University College of Law symposium on Special Needs Trusts and is a regular presenter for NAELA. His presentation at the November NAELA “Advanced Elder Law Institute” was entitled “Is it for You? Representing Social Security/SSI Disability Claimants as Part of Your Elder Law Practice.”

are widely discussed among elder law practitioners. Unfortunately, few of the same practitioners are aware of the national controversy involving the treatment of trusts under the *Restatement of the Law - Trusts 3d* (hereafter “*Restatement 3d*”) <sup>3</sup> and the *Uniform Trust Code* (hereafter “*UTC*”).<sup>4</sup> 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.

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 grantor – 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 elder law and trust practitioner must be familiar – and keep current – with (1) individual state laws regarding “spendthrift provisions” and (2) the implementation of the *Restatement 3d* or (3) the *Uniform Trust Code* (or a variation thereof) in that state. Statutes being 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 *UTC* and the *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 more freedom to define the extent to which spendthrift protection may be invaded. Certain provisions of the *UTC* and the *Restatement 3d* have been referenced as threats to our use of trusts to accomplish effective asset protection and public benefits planning. Therefore, in addition to a specific analysis of using Third-Party Special Needs 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.<sup>5</sup>

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<sup>3</sup> *The Restatement of the Law Third - Trusts*, American Law Institute, Vol. 1 and Vol. 2, American Law Institute Publishers (2003).

<sup>4</sup> *Uniform Trust Code* (National Conference of Commissioners on Uniform State Laws, as last amended 2005).

<sup>5</sup> This author will be involved in 2 presentations during 2007 on the *Uniform Trust Code* and its potential affect on Special Needs Trusts: (1) An individual presentation entitled “SNTs in a UTC Environment: Is Third-Party Disability Planning at Risk?” [State Bar of Texas, Advanced Elder Law Course, Houston, March 8-9, 2007] and (2) A panel presentation entitled “The Effect of the *Uniform Trust Code* (UTC) on Special Needs Trusts (SNTs): A Panel Discussion From Both Sides” (2007 NAELA Symposium, Cleveland, May 3-6, 2007).

PART 1  
SNT BASICS

I. DEFINITIONS

The following list includes definitions which must be understood in order to successfully implement trusts in the practice of elder law.

A. SNT Trust Terminology Defined

1. Complex Trust

A trust which is not required to distribute its accumulated income at least annually.

2. 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.

3. 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. By including certain provisions in a third-party trust, the grantor may intentionally retain sufficient control to be treated as the owner so that he will be taxed for income tax purposes, thus allowing more trust assets to be available to the beneficiary.

4. 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.

5. 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 non-means tested programs.

6. POMS [Program Operations Manual System]

The POMS is the set of rules used by the Social Security Administration in 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.

7. *Restatement of the Law Third - Trusts (Vol. 1 and Vol. 2)*

This is the third edition of the treatise on trusts as adopted and promulgated by the American Law Institute in Washington, D.C. The latest edition bears the copyright date of 2003. The Restatement is universally cited by courts and authors. Numerous states, including Texas, have adopted portions of the Restatement into their trust codes.

8. 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.

9. Simple Trust

A simple trust is one which requires that all income be distributed at least annually by the terms of the trust. Income may not be accumulated.

10. 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).

11. *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. As of January 1, 2007, the *UTC* has been adopted by 18 states and the District of Columbia.

## 12. 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.

## 13. (d)(4)(A)

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

## II. DEFINING THE THIRD-PARTY SPECIAL NEEDS TRUST

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.

In defining the “Third-Party Special Needs Trust,” it is more logical and understandable to define the terms in reverse order: (1) Trust; (2) Special Needs; and (3) Third-Party.

### A. Trust

In his new treatise on estates and trusts, Professor Jeffrey Pennell, the estate planning guru from the Emory University School of Law, 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.”<sup>6</sup>

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<sup>6</sup> Pennell and Newman, *Estate and Trust Planning* (ABA 2006), at 219.

The Social Security Administration's *Program Operations Manual System* (POMS) specifically defines the term trust: "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)." <sup>7</sup>

The Texas Medicaid definition appears at 1 TAC §358.417(a)(2):

A trust includes any legal instrument, device, or arrangement which may not be called a trust under state law, but which is similar to a trust. That is, it involves a grantor who transfers property to an individual or entity with fiduciary obligations with the intention that it be held, managed, or administered by the individual or entity for the benefit of the grantor or others. This can include burial trusts, limited partnerships, and other similar entities managed by an individual or entity with the fiduciary obligations.

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 "Special Needs Trust Eligibility Rules - 2003," the outstanding SSI expert David J. Lillisand 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..." <sup>8</sup>

I have outlined the some common classifications of trusts below, including the characteristics of each.

#### 1. Simple v. Complex

For income tax purposes, trusts commonly are divided into two groups: simple trusts and complex trusts.<sup>9</sup> These terms are not used in the IRS Code, but they are used in the Regulations.<sup>10</sup> The generally accepted definition of 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.<sup>11</sup>

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<sup>7</sup> Social Security Administration Program Operations Manual System (POMS), SI 01120.200.

<sup>8</sup> David J. Lillisand, "Eligibility Rules of Supplemental Security Income (SSI) - 2003" (Supplemental Needs Trusts V, Stetson University College of Law CLE, 2003). Emphasis supplied by author.

<sup>9</sup> Pennell, *supra*, at 478.

<sup>10</sup> *Id.*, at 478.

<sup>11</sup> *Id.*, at 478.

The generally accepted definition of a “complex trust” is any trust that does not qualify as a “simple trust.” 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.<sup>12</sup> 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.<sup>13</sup>

## 2. Revocable v. Irrevocable

A revocable trust may be revoked, modified or amended by the grantor 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.<sup>14</sup> In Texas, all trusts are revocable unless the trust specifically states by “express terms of the instrument creating it” or “modifying it” that it is irrevocable.<sup>15</sup>

## 3. Inter vivos v. Testamentary

An “inter vivos trust” is a trust that is created and implemented during the lifetime of the grantor; i.e. a revocable living trust or an irrevocable life insurance trust. A “testamentary trust” is a trust that is created in a testamentary document such as a Will and is intended to be implemented subsequent to the death of the grantor; i.e. a support trust for children created in the grantor’s Will or an Inheritance Trust created for children and grandchildren as part of a revocable living trust which will only come into effect upon the death of the grantor of the living trust.

For tax purposes, an inter vivos trust is activated when created and funded by the grantor. 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.<sup>16</sup>

## 4. Self-settled v. Third Party

Self-Settled Trusts are funded with assets owned by the beneficiary of the trust. Third-Party Trusts are funded with assets owned by someone other than the beneficiary of the trust. The distinction between Self-Settled and Third-Party Trusts are discussed in detail at Part III below.

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<sup>12</sup> *Id.*, at 480.

<sup>13</sup> *Id.*, at 481.

<sup>14</sup> *Texas Property Code*, Title 9, §112.051(a)

<sup>15</sup> *Id.* §112.051(c)

<sup>16</sup> Finn and Lavelle, *The Complete Trust Guide* (PESI 2006), at 1-1.

## 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.<sup>17</sup> 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.<sup>18</sup>

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 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.

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<sup>17</sup> Myers and Bourland, “Grantor Trusts Including Grantor Retained Interest Trusts, Qualified Personal Residence Trusts and Intentionally Defective Grantor Trusts” (State Bar of Texas, 28<sup>th</sup> Adv. Estate Planning and Probate Course, 2004), at 1.

<sup>18</sup> Pennell, *supra*, at 490.

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. A new provision under Texas Probate Code §§867-874 now allows the creation of an 867 Trust without the necessity of a guardianship.

### B. Special Needs

Trusts are utilized by estate planning attorneys to achieve a diverse array of goals: (1) Income and Estate Tax savings; (2) Competent management by non-beneficiaries for the benefit of those not deemed capable; (3) Asset protection from creditors and potential ex-spouses; and (4) Guardianship avoidance to name a few.

Elder Law attorneys use trusts as planning tools to assist the client in acquiring or maintaining public benefits which would otherwise be denied to the client if he or she owned - or could access - the assets outright, in the beneficiary's individual capacity. Trusts are used to define or limit both countable income and countable resources for public benefits eligibility. 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.<sup>19</sup> Proper use of this trust, as well as the other trusts listed 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.

### C. Third-Party

"Third-party" trusts are trusts which are funded with property owned by 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. A more detailed discuss of the third-party trusts is found in Part IV below .

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<sup>19</sup> 42 U.S.C. 1396p(d)(4)(A).

### III. SELF-SETTLED V. THIRD-PARTY TRUSTS

“Self-settled” trusts are trusts which are funded with the beneficiary’s own property. The “beneficiary” may, or may not, be the “grantor.” In the traditional living trust, the grantor 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 grantor. 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 funded with property of someone other than 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 “third-party” 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.

#### IV. MEANS TESTED V. NON-MEANS TESTED PUBLIC BENEFIT PROGRAMS

Public benefit 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.

##### A. Means Tested 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 Medicaid and Supplemental Security Income (SSI).

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.

##### B. Non-means Tested Programs

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 Medicare and Social Security Disability (SSD).

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.

##### C. Using Trusts in Disability Planning

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.

As a general rule, disability planning with trusts applies only to “means tested” programs. In order to facilitate eligibility for public benefits, trusts may be 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.

## PART 2 THE PROGRAMS

### V. THE “MEANS TESTED” PROGRAMS

#### A. Medicaid <sup>20</sup>

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 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.

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<sup>20</sup> Since the topic of this paper is Third-Party Special Needs Trusts, a comprehensive discussion of the Medicaid program is not included. This section presents a short over-view of the Texas Long Term Nursing Home Medicaid Program. For a detailed examination of the program, see Clyde Farrell’s latest version of his treatise entitled *Financing Long-Term Care in Texas* (Vol. 12.0, January 2007) available by contacting Clyde at [cfarrell@texas.net](mailto:cfarrell@texas.net) or Molly Dear Abshire, *Elder Law Planning and Issue Spotting*, 8<sup>th</sup> Annual Building Blocks of Wills, Estates and Probate Course (State Bar of Texas, January, 2007). Other recent articles on the Medicaid Program in Texas have been written by Wes Wright, Pi-Yi Mayo, Patty Sitchler, and Rene Lovelace.

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.

### 1. 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)

### 2. 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 its 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.

#### a. 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 2007 monthly SSI benefit amount is \$923. Therefore, the 2007 income cap is \$1,869. 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.

b. 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 resources, 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 1 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 1 vehicle of any value for most states.

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 contiguous 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).

#### B. Supplemental Security Income (SSI) <sup>21</sup>

Supplemental Security Income (hereafter “SSI”) is a federal poverty program for individuals who are either aged, blind or disabled. <sup>22</sup> The rules which govern the program are found in federal statutes. <sup>23</sup> 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. <sup>24</sup> A version of the POMS for the public can be found at [www.ssa.gov](http://www.ssa.gov). <sup>25</sup> 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.

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<sup>21</sup> Since the topic of this paper is Third-Party Special Needs Trusts, a comprehensive discussion of the SSI program is not included. This section presents a short over-view of the Supplemental Security Income Program. For a detailed examination of the program, see Clyde Farrell’s latest version of his treatise entitled *Financing Long-Term Care in Texas* (Vol. 12.0, January 2007) available by contacting Clyde at [cfarrell@texas.net](mailto:cfarrell@texas.net) or David J. Lillesand, “Special Needs Trust Eligibility Rules - 2006” (Supplemental Needs Trusts VIII, Stetson University College of Law CLE, 2006). Other recent articles on the SSI Program have been written by Wes Wright, Pi-Yi Mayo, Patty Stichler, and Rene Lovelace and others. Many of these articles can be found in the State Bar of Texas Online Library.

<sup>22</sup> POMS, SI 00501.001

<sup>23</sup> 20 CFR §416.

<sup>24</sup> There is an electronic version of the CFR on the web which can be found at <http://ecfr.gpoaccess.gov>.

<sup>25</sup> To access the POMS at [www.ssa.gov](http://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, it is important to understand that all three categories must be satisfied.

### 1. SSI Benefits

SSI payments are intended to provide income to be used for food and shelter.<sup>26</sup> 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 2007, the maximum monthly payment is \$623 for an individual and \$934 for a married couple who both qualify. The amount is adjusted annually.<sup>27</sup>

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](http://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.

### 2. 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.

#### a. Categorical Requirements

The SSI applicant must be either (1) age 65 or older, (2) blind or (3) disabled.<sup>28</sup> 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.*<sup>29</sup>

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<sup>26</sup> 20 C.F.R. § 416.110.

<sup>27</sup> 42 U.S.C. § 1382f(a).

<sup>28</sup> 42 U.S.C. § 1382c(a)(1)(A).

<sup>29</sup> Social Security Act, § 216(i)(1) [42 U.S.C. 416]; 20 CFR § 416.905.

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.<sup>30</sup> This definition will be indexed for inflation. For 2007, SGA is \$900 for a non-blind individual and \$1,500 for a blind individual.

b. 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.

c. 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 2007, the countable income limit for an unmarried person is \$623 and \$934 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.<sup>31</sup> 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.<sup>32</sup>

“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.

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<sup>30</sup> 69 Fed. Reg. 62497(12) (Oct 26, 2004).

<sup>31</sup> 42 U.S.C. § 1382a(a).

<sup>32</sup> 20 C.F.R. §§ 416.1112(b), (C).

d. In-kind Support and Maintenance

In-kind Support and Maintenance [ISM] is food or shelter furnished to the SSI recipient by a someone else.<sup>33</sup> 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-third Reduction Rule." [For 2007 = \$623 divided by 3 = \$207.67; \$623 - 207.67 = \$415.33; Therefore, the amount of benefit for that month = \$415 + 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.<sup>34</sup> [For 2007 = \$623 / 3 = \$207.67 + \$20 = \$227.67; \$623 - \$227.67 = \$395.33; Therefore, the amount of benefit for that month = \$395 + ISM provided].

[Note: The accuracy of the examples above are 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.

e. 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 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,

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<sup>33</sup> 20 C.F.R. § 416.1130

<sup>34</sup> 20 C.F.R. § 416.1131.

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.

f. 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."<sup>35</sup> 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 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.<sup>36</sup>

g. 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).

h. Non-institutionalization

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

3. 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.

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<sup>35</sup> 20 C.F.R. § 426.1201(a).

<sup>36</sup> 20 C.F.R. § 416.1210.

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:  $\$10,000 / 623 = 16$  month penalty. Whereas the Medicaid program has no maximum penalty period, the SSI program has a maximum penalty period of 36 months.

#### 4. 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.

#### 5. 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](http://www.ssa.gov).

#### 6. Conclusion

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.

## PART 3 LEGAL ISSUES AFFECTING TRUSTS

### VI. SPECIFIC APPLICATIONS OF TRUST LAW AFFECTING SNTS

#### 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 grantor, 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.

### VII. ISSUES INVOLVING THE *RESTATEMENT 3d* AND THE *UTC*

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. Much of the controversy involves the treatment of Third-Party SNTs. Issues such as “notice to beneficiaries,” “beneficiary as trustee,” and “exemption creditors” are discussed regularly in trust literature. However, it is the “trustee’s duty of good faith” in discretionary trusts that has caused the most heated rhetoric.<sup>37</sup> Prior to January 1, 2006, the *Texas*

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<sup>37</sup> A presentation discussing potential adverse affects of the *UTC* on Third-Party SNTs was given at the Noveber 2006 NAELA Advanced Elder Law Institute was given by Mark W. Worthington, LL.M., CELA, entitled “Will the Uniform Trust Code Negatively Affect a Third Party’s SNT?” An article taking the opposing position written by Richard E. Davis CELA and Stanley C. Kent entitled “The Impact of the Uniform Trust Code on Special Needs Trusts” appeared in 1 *NAELA Journal* 235 (2005).

*Trust Code* required a duty of loyalty and common law duties, but did not specifically require a mandatory “duty of good faith.”<sup>38</sup> The 2005 legislature adopted the *Uniform Trust Code* definition of duties<sup>39</sup> which may not be waived by the terms of the trust, including the duty of the trustee “to administer the trust in good faith according to its terms.”<sup>40</sup> The issue that is raised by this mandatory addition to the code is whether or not the standard of judicial review of trusts has been lowered; thus allowing the beneficiary of a discretionary trust to compel distributions from the trust irrespective of the distribution terms written and intended by the grantor.<sup>41</sup> Does this create an additional right which may render the corpus “available” to the beneficiary?<sup>42</sup> If not now, what about future changes in the Texas Medicaid eligibility rules?<sup>43</sup>

Additionally, one should be familiar with the on-going debate over Article Five of the *Uniform Trust Code* (“UTC”) which addresses the rights of creditors with regard to satisfying claims from trusts and addresses the distinction between “support trusts” and “discretionary trusts.” This issue is critical to elder law practitioners since many utilized a “purely discretionary trust” as the third-party SNT of choice.

As of the Summer of 2006, the *UTC* has been adopted in 19 jurisdictions and is being considered in several others.<sup>44</sup> An excellent overview of the *UTC* has been written by I. Mark Cohen and appears in the Fall 2006 edition of the *NAELA Journal*.<sup>45</sup>

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<sup>38</sup> Patterson, Hopwood and Donoho, “Fiduciary Liability – Recent Developments & Prevailing Trends Regarding Executors and Trustees” (State Bar of Texas 2006 *Fiduciary Litigation Course*), at p. 3.

<sup>39</sup> *UTC* Section 814(a).

<sup>40</sup> *Texas Trust Code* §111.0035, effective January 1, 2006.

<sup>41</sup> C. Boone Schwartzel, “A Texas Trustee’s New Duty to Inform: Beware of the Creeping Uniform Trust Code” (State Bar of Texas, 12<sup>th</sup> Annual Advanced Estate Planning Strategies Course, April 2006). At page 3, Mr. Schwartzel states “...in some places the UTC goes too far in empowering courts to override settlor intentions...”

<sup>42</sup> Mark Merric and Douglas W. Stein, “A Threat to All SNTs” (*Trusts and Estates*, November 2004) at p. 40.

<sup>43</sup> For differing views on this issue, see (1) Richard E. Davis CELA and Stanley C. Kent, “The Impact of the Uniform Trust Code on Special Needs Trusts” 1 *NAELA Journal* 235 (2005) and (2) 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).

<sup>44</sup> 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.

<sup>45</sup> I. Mark Cohen, Esq., “The Top Fourteen Things You Need to Know About the Uniform Trust Code,” 2 *NAELA Journal* 259, 278 (2006).

Some of the most experienced and respected trust and estate attorneys in Texas have not been particularly pleased with the adoption of certain *UTC* provisions into the *Texas Trust Code*.<sup>46</sup> C. Boone Schwartzel begins his article written for the *2006 Advanced Estate Planning Strategies Course* with these words: “I fear that the Uniform Trust Code (“UTC”) is slowly but surely “creeping” its way into Texas law with adverse results.”<sup>47</sup> His opinion is that the UTC tends “to reform, rather than simply codify, existing law.”<sup>48</sup> (emphasis by original author). In commenting as to why the Texas Real Estate, Probate and Trust Law Section committee on the UTC recommended against its adoption, Glenn Karisch states that the committee felt that the Texas Trust Code “...is superior to the UTC in many ways and should be retained.”<sup>49</sup>

A. *Restatement 3d* and the *UTC*: General Trust Issues

1. *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 potentially move the scale in favor of creditors.

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<sup>46</sup> Schwartzel, *infra.* and Glenn M. Karisch, “2005 Texas Legislative Update” which is found at [www.texasprobate.com](http://www.texasprobate.com) (2005).

<sup>47</sup> Schwartzel, at 3.

<sup>48</sup> Mr. Schwartzel states on page 3: “In sum, in my opinion Texas lawyers generally have done a much better job in drafting legislation than the National Council of Commissioners of Uniform State Laws because Texas lawyers generally have sought to codify, rather than reform, trust laws absent a compelling public policy reason for change.”

<sup>49</sup> Karisch, at 2.

## 2. *Uniform Trust Code*, Article Five

The *Uniform Trust Code* is meant to be the first national codification of the law of trusts.<sup>50</sup> 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.<sup>51</sup> 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 authored numerous articles on the subject of *UTC* Article Five.<sup>52</sup> In an often quoted article addressing the issue of creditor's rights, Professor Robert T. Danforth, an ardent supporter of the *UTC*, speaks in terms which appear to be somewhat derogatory, referring to opponents as "a small segment of the estate planning bar, most of whom apparently focus their practice on so-called asset protection."<sup>53</sup>

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 may 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 potentially be at risk in *UTC* states.<sup>54</sup>

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<sup>50</sup> *Id.*, at 11.

<sup>51</sup> Robert T. Danforth, "Article Five of the *UTC* and the Future of Creditors' Rights in Trusts" (2005), at 18.

<sup>52</sup> 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.

<sup>53</sup> Danforth, *supra*, at 4.

<sup>54</sup> Cohen, *supra*, at 120.

### 3. The “Spendthrift” Trust

At common law, by Restatement<sup>55</sup> and as codified in various trust statutes, grantors 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.”<sup>56</sup>

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.”<sup>57</sup> With regard to third-party beneficiaries, however, Texas courts have long recognized that a grantor “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.”<sup>58</sup> The right to establish a spendthrift trust has been approved by the Restatement of Trusts 2d since 1959.<sup>59</sup> 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.<sup>60</sup> The problems appear to have their roots in the *Restatement 3d* and the *UTC*.

The Texas Trust Code section entitled “Spendthrift Trusts” was amended in 2006<sup>61</sup> 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.<sup>62</sup>

### 4. The “Ascertainable Standard”

The traditional “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.

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<sup>55</sup> Mario A. Mata, “Increasing Creditor and Divorce Court Attacks on Spendthrift Trusts” (Wills, Probate and Elder Law Institute - University of Houston Law Foundation, 2006), at 3.

<sup>56</sup> Mata, *supra*, at 3.

<sup>57</sup> *Id.*; *Matter of Shurley*, 115 F.3d at 337 (5<sup>th</sup> Cir 1997).

<sup>58</sup> *Adams v. Williams*, 248 S.W. 673 (Tex. Comm. App. 1923).

<sup>59</sup> Restatement of the Law, 2d, Trusts (American Law Institute 1959), at § 152.

<sup>60</sup> The problems appear to have their roots in the Restatement of Trusts 3d (2003) and the *Uniform Trust Code* (see sub-parts C, D).

<sup>61</sup> Texas Trust Code, § 112.035(f).

<sup>62</sup> *Id.* at § 112.035(f)(1)(A)(ii).

In the 2005 amendment to the Texas Trust Code, the ascertainable standard is one of the bricks used to build the wall around the spendthrift trust, even if the beneficiary is acting as trustee.<sup>63</sup> 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. Mata involved trusts which either had no ascertainable standard or improperly attempted to include such a standard by deviating from acceptable language.<sup>64</sup>

**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 along way toward defeating the “desired” goal of creditor protection.<sup>65</sup>

#### B. *Restatement 3d* and the *UTC*: Issues Involving Third-Party SNTS

In disability trust planning, it is imperative that trust assets be categorized as “unavailable” to the beneficiary in order to classify the assets as “non-countable resources.” Traditionally, when the trustee is given broad discretion in making determinations regarding distributions, the right of the beneficiary to receive distributions has been referred to as a “mere expectancy.” As a result, the beneficiary has had little judicial recourse to challenge the trustee’s decisions. If the judicial standard for review is lowered, is it not logical that the beneficiary has increased standing to challenge the conduct of the trustee in a court action? If the beneficiary can obtain judicial remedy for a trustee’s failure to make distributions, then is it not possible that the trust assets might be classified as “available” to the beneficiary? How then would that affect the beneficiary’s eligibility in light of the available resources in the trust?

While these issues are being hotly debated, the questions will only be answered by future actions of legislatures, courts and the CMS.<sup>66</sup>

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<sup>63</sup> Id.

<sup>64</sup> Mata, *supra*, at 8-9.

<sup>65</sup> Id. at 8.

<sup>66</sup> On page 44 of their article in *Trust and Estates Magazine*, Mark Merric and Doug Stein have included language which they suggest should be included in every Third-Party SNT. See Merric and Stein, *infra*. at fn 42.

C. *Restatement 3d* and the *UTC*: Current Literature

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):

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

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).

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

Jeffrey A. Schoenblum, "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).

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).

Mark W. Worthington, LL.M., CELA, "In Opposition to the Enactment of the Uniform Trust Code" *NAELA Trust SIG News* (2005).

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, 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 and Michelle Berger, “The Uniform Trust Code: A Continuum of Discretionary Trusts or A Continuum of Continuing Litigation” *Estate Planning* (Dec. 2004-Jan. 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.

#### VIII. CURRENT TEXAS LAW: TREATMENT OF DISTRIBUTIONS FROM TRUSTS

The *Texas Medicaid Eligibility Handbook* (MEH) makes a distinction between third-party trusts and self-settled trusts<sup>67</sup> regarding the classification of trust corpus. MEH 2313.2 entitled “Testamentary and Inter Vivos Trusts” addresses trusts in which the beneficiary’s assets “are not used to form the corpus of the trust.” Citing 1 TAC §358.414(d), the current rule states:

Resources in a testamentary or inter vivos trust are countable if the client is the trustee and has the legal right to revoke the trust and use the money for his own benefit. If he does not have access to the trust, the trust is not counted as a resource. If a trust is not counted as a resource, payments from the trust made to or on behalf of the client are considered to be income (except payments used to purchase medical or social services for the client). If the client’s access is restricted; that is, only the trustee (other than the client) or the court may withdraw the principal, then the value of the trust as a resource is not counted. This is true even if

- (1) the legal guardian is the trustee;
- (2) the trust provides a regular, specified payment to the client; or
- (3) the trust provides for discretionary withdrawals by the trustee.

Accordingly, if the beneficiary (1) is not the trustee; (2) cannot revoke the trust; and (3) cannot access the money for his own benefit, then distributions from the trust are considered “income” to the beneficiary, but the corpus of the trust is not considered as countable.

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<sup>67</sup> The Texas Medicaid rules with regard to treatment of distributions from self-settled trusts are found at 1 TAC §358.417.

## IX. EFFECTIVE DATE OF THE TRUST: TESTAMENTARY OR INTER VIVOS

Third-Party SNTs are regularly drafted as testamentary trusts and as inter vivos trusts. The determination as to when the trust will be implemented depends upon the circumstances of the grantor, the beneficiary and possibly other potential donors. Some of the considerations making this determination are as follows:

### A. In Favor of Inter Vivos Implementation

1. Grantor has a sizable estate and wants to make a current gift to the trust in order that future appreciation of the asset will occur within the trust and not in the grantor's taxable estate.
2. Grantor wants to make annual exclusion gifts to the trust.
3. Other third parties, such as siblings or grandparents, want to benefit the beneficiary in their testamentary planning and wish to name the trust as a devisee under their Will or under a non-testamentary beneficiary-driven asset, such as life insurance or a P.O.D. account.
4. The trust can be funded and submitted to HHSC for a determination as to whether the trust qualifies as an "unavailable resource." After giving approval to the trust, it might be more difficult to rule such assets as countable in the case of a future change in the law.

### B. In Favor of Testamentary Inclusion

1. None of the reasons set out in 1 - 3 above are relevant.
2. There is no reason to have a current administration of a trust.
3. Grantor has limited resources; a testamentary trust is usually less expensive.

## X. IMPLEMENTING A STRICT SNT OR A PURELY DISCRETIONARY SNT

The grantor can determine what type of distribution standard to include in the trust. Usually, the standard is going to limit distributions to "special needs" which are defined in the trust; or alternatively, the trustee is given full and absolute discretion to make distributions which he determines to be in the beneficiary's best interests ( This discretion often allows the trustee to make no distributions whatsoever); or finally, a distribution scheme which is a combination of both.

In the past, SNT drafters often restricted distributions to “special needs” or “supplemental needs” and prohibited distributions for “support needs.” This was done in fear that any distribution for support of the beneficiary would have an adverse affect on his receipt of public benefits. While it is true that such distributions will affect the benefits received, it is not always an adverse result. SSI practitioners are aware of In-kind support and maintenance (ISM) which can be a very valuable benefit, but which may reduce monthly cash benefits by one-third. If the trust prohibits such distributions, the trustee will breach his fiduciary duty if he makes prohibited distributions, even if it is apparent that such benefits would be in the best interests of the beneficiary.

The current thinking is that restricting distributions to supplemental needs and thus preventing the trustee from making distributions for food and shelter is bad practice if the beneficiary’s state does not have a restrictive statute limiting distribution rules. In his article, “Special Needs Trust Eligibility Rules” given regularly at the Stetson University College of Law annual SNT symposium, David J. Lillesand includes a chart comparing the actual monetary benefit of allowing ISM distributions as opposed to restricting support distributions.<sup>68</sup> This author has heard Mr. Lillesand go as far as to describe the prohibition of ISM in a SNT as “malpractice.”

This author’s opinion is that a Texas Third-Party SNT should:

- A. Use a purely discretionary distribution standard;
- B. Should give numerous examples of what “special” or “supplemental” needs are intended by the grantor; and
- C. Should specifically provide that the trustee may make distributions for ISM .

## XI. ISSUES INVOLVING REVOCABILITY

Trusts are either “revocable” or “irrevocable.” Some trusts begin as revocable, but may be made irrevocable on the happening of a certain event, such as the death of a grantor. The issue of whether or not to consider using a revocable trust is applicable only to inter vivos trusts. Testamentary trusts are always irrevocable.

There is no rule requiring that a Third-Party SNT be irrevocable. The Texas rule is that the beneficiary cannot have the ability to revoke the trust. In a revocable trust, it is usually the grantor who holds the authority to revoke the trust.

Some well-known elder law attorneys espouse revocable Third-Party SNTs during the lifetime of the grantor which become irrevocable upon the death of the grantor (or the last of the grantors, if more than one).<sup>69</sup> While I am not questioning their decision in drafting, as a personal

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<sup>68</sup> Lillesand, *infra.* at 22.

<sup>69</sup> This technique is used by Tom Begley, Jr. in his treatise, *Representing the Elderly and Disabled Client* (with Cynthia Barrett and Andrew H. Hook - Warren, Gorham & Lamont, 2001).

preference, I do not like using revocable trusts for any purpose in disability planning. The Medicaid rules involving revocable trusts continue to increase against eligibility, such as the 2006 determination that an otherwise exempt residence held in a revocable trust is now a countable resource. My preference is based upon perception and the sophistication (or lack thereof) on the part of the individual making the eligibility determination based upon my trust.

If tax planning issues are involved in the funding of the trust, the trust must be irrevocable in order to have completed gifts from the donor to the trust (see Section XIV below).

## XII. PORTABILITY ISSUES: SNTS ON THE MOVE

What happens when it is anticipated that the residence of the trustee or beneficiary may change in the future? Since the rules regarding SNTs vary from state-to-state, this can present a drafting problem.

Most portability issues are applicable to d4A trusts as opposed to Third-Party SNTs. This is true due to the “pay-back” provisions that are required under state law. Even if the “payback” provision included in the trust was valid in the state in which it was drafted, the same provision may fail the test in a subsequent state of residence under whose law the beneficiary must now qualify.<sup>70</sup>

Thankfully, Third-Party SNTs do not share this particular problem. However, problems can be encountered in states which have adopted *Restatement 3d* §60. This section states:

Subject to the rules stated in §§58 and 59 (on spendthrift trusts), 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 distribution the trustee makes or is required to make in the exercise of that discretion after the trustee has knowledge of the transfer or attachment.

Although this provision does not apply if the trust contains a valid spendthrift clause, traditional spendthrift protection is being eroded by the *Restatement* which has now begun to define certain types of “exception creditor” whose claims can be satisfied out of a trust, irrespective of the grantor’s intent as demonstrated by the inclusion of a spendthrift clause. Because of this potential problem, I am careful when drafting “discretionary” distribution language if called upon to draft a testamentary SNT for a beneficiary who resides in another jurisdiction.

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<sup>70</sup> An excellent article was presented on this topic at Stetson’s *Special Needs Trusts VIII* in October of 2006 by Leigh H. Bernstein. Ms. Bernstein’s article is entitled “SNTs on Wheels.”

### XIII. DRAFTING THE SNT WITH TAXES IN MIND <sup>71</sup>

#### A. Estate Taxes

If one of the third-party donor's goals is to obtain estate tax benefits, the federally taxable estate of the donor can be decreased by making completed gifts to the trust. The donor can make a gift of any amount to the trust. However, for estate and gift tax purposes, it is important to understand the rules. Each taxpayer has a lifetime federal estate tax exemption of \$2.0 million for 2007. This amount applies only for gifts at death. Lifetime gifts are limited to \$1.0 million. These amounts are doubled for a married couple splitting gifts.

#### B. Gift Taxes

Each taxpayer has an annual gift tax allowance of \$12,000 per donee per calendar year (doubled for a married couple splitting gifts) for 2007. There is no tax due on any gift which is equal to, or less than the federal annual exclusion amount. Any gift which exceeds the annual exclusion amount requires that a U.S. Gift Tax Return be filed with the Internal Revenue Service.

Therefore, the donor can make a lifetime gift of up to \$1.0 (\$2.0 million for a married couple, plus an annual gift tax exclusion amount of \$12,000 per donee without incurring a tax bill. However, any amount which exceeds the annual exclusion amount for the calendar year of the gift requires the filing of a gift tax return. That amount is deducted from the taxpayer's lifetime federal estate tax exemption amount. By way of example, if the donor and spouse make a gift in 2007 of \$2,024,000 (assuming no prior taxable gifts), they will incur no estate or gift taxes for the gift. However, a gift tax return must be filed and the donors have exhausted their full lifetime exemptions (subject to an increase in the federal estate tax exemption in future years). They may still make annual gift tax exclusion gifts each calendar year without further reporting.

For tax planning purposes, the goal of annual exclusion gifting is to decrease the federally taxable estate of the donor which will be subject to estate tax at the donor's death. The goal of lifetime exclusion gifting is to have the future growth of the assets gifted taxed in the estate of the donee, rather than the donor.

#### C. Income Taxes

Income taxation of trusts is a complicated subject which is beyond the scope of this paper. However, a few basics should be understood by those drafting SNTs. The income tax provisions which apply to trusts and their beneficiaries are found in Subparts A-D of Part I of Subchapter J of the IRS Code.<sup>72</sup> In SNT planning, it is uncommon to have a grantor who is concerning with whether or not he will be treated as the owner of the corpus of the trust for income tax purposes.

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<sup>71</sup> For an in-depth discussion of tax matters relating to SNTs, see Stuart Morris, "Tax Saving Strategies for Special Needs Trusts," presented at the Stetson SNT IV conference in 2002.

<sup>72</sup> Pennell, *infra.* at 469.

## 1. Simple Trusts vs. Complex Trusts

Initially, the trust will either be drafted as a “simple trust” or a “complex trust.” A simple trust may not accumulate income and must distribute all income annually. A complex trust is not required to distribute income and may accumulate income. In a complex trust, some income may be distributed and some may be accumulated. A SNT should not be drafted as a simple trust. To do so would require the trustee to distribute all income to the disabled beneficiary. Receipt of such income would at least diminish benefits and could possibly disqualify the beneficiary from public benefits altogether.

Most Third-Party SNTs are drafted as irrevocable, non-grantor, complex trusts. Such trusts fall under the default irrevocable trust income tax rules. As a result, in the typical irrevocable SNT is referred to as a complex trust for income tax purposes. The income generated by the trust may be accumulated and is not required to be distributed annually. The income is allocated to the trust. If the trust generates \$600 or more of income in the reporting period, a Form 1041 must be filed.<sup>73</sup> The trust receives a “distribution deduction” for distributions made during the year. Amounts determined to be distributed taxable income must be picked up by the beneficiary receiving the distributions on his personal 1040. Trust income which is not distributed will be taxed at trust rates which are substantially compressed as opposed to individual rates. The rates escalate to 35% for a mere \$10,450 of income.

## 2. Non-Grantor Trusts vs. Grantor Trusts

The Third-Party SNT is going to be classified as either a “non-grantor trust” or a “grantor trust.” This determination will define to whom the income generated by the trust will be taxed. The Grantor Trust Rules are found in Subchapter J, Subpart E (§§ 671 through 679) of Part I.<sup>74</sup>

In my experience, the majority of inter vivos SNT grantors are not concerned with issues involving the payment of trust income tax. From a practical standpoint, such trusts are established in order to allow grandparents to make testamentary gifts for the benefit of the disabled grandchild which will not disqualify the beneficiary from receiving public benefits. However, it is important for the practitioner to know the basics involved in order to explain how the income tax of the trust he or she drafted for the client will be reported. Additionally, there may be cases in which the grantor is a high net worth, high income taxpayer who wants his choices explained.

The typical SNT is an irrevocable, complex, non-grantor trust. The income of the trust will be attributed to the trust. Distributed income will be taxed to the beneficiary at individual rates. Accumulated income will be taxed to the trust at trust rates.

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<sup>73</sup> IRC 6012(a)(4).

<sup>74</sup> Id. at 490.

If the grantor wants to maximize the trust corpus and decrease the size of his individual taxable estate, he can elect to have the trust drafted as a “grantor trust.” Being taxed as a grantor trust means that the grantor has retained sufficient control, ownership or enjoyment over the trust to intentionally violate the traditional rules of gifting – once made, a completed gift to a trust is no longer subject to the control or enjoyment of the grantor. As Professor Pennell restates the rule:

The key to application of the grantor trust rules is whether the grantor enjoys any trust benefits, has retained so much control, or has left so many “strings” attached to the trust that the grantor should be regarded as the true owner of the trust property for income tax purposes.<sup>75</sup>

A typical example of a grantor trust provision is giving the grantor the retained right to retrieve property that he has funded into the trust by substituting property of equal value.<sup>76</sup> By intentionally retaining one or more of these powers when the trust is created, the grantor will cause all income attributable to the amounts he has funded into the trust to be taxed to himself. The result is to allow the maximum amount of assets to remain in the trust and to intentionally decrease the size of the grantor’s estate for federal estate tax purposes. A grantor trust is not required to file a Form 1041.<sup>77</sup>

The complexity of trust income taxation and the differing options and results are a prime example of why SNT drafting is not a “forms” practice.<sup>78</sup>

#### PART IV DRAFTING THE THIRD-PARTY SNT

#### XIV. AN ANALYSIS OF THE THIRD PARTY SPECIAL NEEDS TRUST

##### A. Defining the Trust: the Grantor’s Intent

**1.03 Intent of Grantor in Establishing this Trust. It is the intent of the Grantor that this Trust shall create a fund which shall be used by the Trustee for the sole benefit of the Beneficiary during his lifetime to supplement and not to supplant income from public benefits to which the Beneficiary may be entitled. This Trust is not intended to provide the primary support of the Beneficiary. It is intended that distributions from this Trust shall enhance the quality of life of the Beneficiary. The decisions of the Trustee in this regard are final.**

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<sup>75</sup> Id. at 491.

<sup>76</sup> IRC §675.

<sup>77</sup> The grantor trust reporting requirements are found at Treas. Reg. Section 1.671-4(b).

<sup>78</sup> An excellent brief discussion of these trust income tax principles is found at NYSBA *Elder Law Attorney*, Winter 2007, Vol. 17, No. 1 ([www.nysba.org](http://www.nysba.org)).

B. Identifying the Parties: The Grantor

The grantor of a Third-Party SNT can be anyone other than the beneficiary. There are no statutory requirements such as the ones which exist for a self-settled d4A SNT (parent, grandparent, guardian or court). There can be more than one grantor. This is a common practice when both parents are establishing a SNT for a disabled child. I always specifically identify the grantor(s) by name and place of residence. I also stress that the grantor has no interest in the assets of the trust. I say this more than once in my trust.

- 2.01 Name of Grantor. The Grantor of this Trust is <Grantor> (hereafter referred to as the “Grantor”).**
- 2.02 Residence of Grantor. The Grantor is a resident of <County> County, Texas whose address is <street>, <City, State, Zip>.**
- 2.03 Grantor Has No Benefit In Trust. The Grantor shall have no benefit of any type, whether directly or indirectly, including any remainder interest, in this Trust.**

C. Identifying the Parties: The Beneficiary

I draft only SNTs with a single lifetime beneficiary. I do not have multiple beneficiaries in my trusts. I state the name of the beneficiary, including residency. Stating the jurisdiction of residency is one of the factors to bolster my adoption of Texas law for all purposes as the controlling law under which the trust is to be administered.

I identify the beneficiary as the “sole” lifetime beneficiary of the trust. I specifically state that the Beneficiary is a disabled person as defined under the Social Security Act.

- 3.01 Primary Beneficiary. The Beneficiary is <Beneficiary>. He shall be the sole beneficiary of this Trust for the remainder of his life. The Beneficiary is a disabled person as defined in §1614(a)(3) of the Social Security Act.**
- 3.02 Residence of Beneficiary. The Beneficiary is a resident of <County> County, Texas whose address is <street>, <City, State, Zip>.**

D. Termination of the Trust

- 3.03 Termination of Trust. This Trust shall terminate upon the death of the Beneficiary. At that time, the Trustee shall conclude the administration of this Trust by paying all claims and expenses which are legally enforceable and by taking all reasonable and necessary actions required by Trustee in closing the administration of a Trust.**

This section clear indicates that the trust will terminate when the sole lifetime beneficiary dies. The actions required of the trustee in winding up the business of the trust are stated. These actions are required prior to distribution of the net assets to the remaindermen.

E. Identifying the Parties: The Remainder Beneficiaries

**3.04 Residuary Beneficiaries. Upon termination, the Trustee shall distribute all remaining assets of this Trust to the Grantor’s surviving children, equally, on a *per stirpes* basis (the “remainder beneficiaries”). In addition to <Beneficiary>, the children of the Grantor are <Children>.**

**3.05 Grantor Has No Benefit In Trust. The Grantor shall have no benefit of any type, whether directly or indirectly, including any remainder interest, in this Trust.**

The remainder beneficiaries should be listed by name. It should also be clear whether the residuary beneficiaries take on a *per capita* basis or on a *per stirpes* basis. It is imperative that the remainder beneficiaries are not simply named by category; i.e. “all remaining trust assets shall pass to the grantor’s heirs at law.” The Social Security Administration may take the position as espoused in the Doctrine of Worthier Title<sup>79</sup> which states that if remainder beneficiaries are identified only as intestate heirs, then the lifetime beneficiary has the right to revoke the trust and the corpus becomes an available resource.

F. Identifying the Parties: The Trustee and Successor Trustees

**4.01 Initial Trustee. The initial Trustee of this Trust is <Trustee> (hereafter referred to as the “Trustee”). The Trustee is a resident of <Trustee County>, Texas.**

**4.02 Successor Trustee. If the Trustee should die, resign or otherwise cease to serve as Trustee, then <Successor Trustee 1> shall act as sole Trustee of the Trust. If <Successor Trustee 1> should die, resign or otherwise cease to serve as Trustee, then <Successor Trustee 2> shall act as sole Trustee of the Trust.**

**4.03 Trusteeship Vacant. If all of the Trustees resign or are unable to act for any reason, then the Trust Protector of this Trust (see Article Five below) may appoint either (1) an individual to serve as trustee, or (2) a corporate trustee with trust powers under the laws of the state of the Beneficiary’s residence to act as sole trustee of this Trust. If the trusteeship of the Trust should become vacant for any reason and remain vacant for a period of sixty (60) days, then upon written request of any interested party, the District Court of <County> County, Texas shall have the power to appoint a successor. Any acting trustee (or all Co-Trustees acting jointly if more than one is serving) may appoint a corporate trustee to act as trustee, if it is deemed in the best interests of the Trust.**

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<sup>79</sup> See Part III, Section VI(A) above.

The trustee should be identified by name and place of residence, especially if the he is a resident of Texas. Whether the grantor chooses an individual as trustee or a corporate trustee is a personal determination, based upon several relevant factors.<sup>80</sup> If a corporate trustee is to be considered, it is imperative that the trust company is licensed to serve as a corporate trustee in Texas.

Due to the irrevocability of the trust, I name as many successor trustees as possible. It is important to note that grantors in general do not understand what “irrevocable” means. It is common to get a call from a grantor a year or 2 or more after establishing the trust with a directive to change the successor trustee. For this reason, including a Trust Protector in your trust is very useful. By doing so, you can avoid a trip to district court to change fiduciaries. In my trust, I specifically discuss the procedure to follow if the trusteeship becomes vacant, including the role of the Trust Protector.

G. Identifying the Parties: The Trust Protector and Successors

**5.01 Name of Trust Protector. The Trust Protector of this Trust is <Trust Protector> (hereafter referred to as the “Trust Protector”). The Trust Protector is a resident of <Trust Protector County>, Texas.**

**5.02 Successor Trust Protector. If the Trust Protector is unable to serve for any reason, then the acting Trust Protector may appoint a successor to the office of Trust Protector as specifically detailed in Section 5.03 below. If the office of Trust Protector becomes vacant and the current Trust Protector is unable to appoint a successor, or if the office of Trust Protector remains vacant for a period of sixty (60) days, then a majority of the remainder beneficiaries may appoint an individual to serve as Trust Protector of this Trust.**

Trust Protectors have not been traditionally used in Texas. In fact, I have never seen a Texas trust which names a Trust Protector, although the subject has been raised by Texas CLE articles for several years.<sup>81</sup> Roy M. Adams, the nationally renowned estate planning attorney and author provides a detailed discussion of the issues involving trust protectors in his article entitled “Irrevocable – The ‘I’ Word As Applied to Trusts.”<sup>82</sup> Six states currently have trust protector

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<sup>80</sup> Three excellent resources discussing issues to be considered in making this determination are:

- (1) Wendelyn Wilkes, “Special Needs Trusts, Part I: Third-Party Trusts - A Trustee’s Perspective” (UTCLE Special Needs Trusts 2007).
- (2) I. Mark Cohen, “Appreciating Individual Trustee” (*Trusts & Estates*, December 2006) at 32.
- (3) Barbara Hauser, “Appreciating Corporate Trustees” (*Trusts & Estates*, August 2005), at 52.

<sup>81</sup> Patricia F. Sitchler, CELA, “Supplemental Needs Trusts: A Texas Perspective” (State Bar of Texas *Summer School 2004*) at 29.

<sup>82</sup> *The 2006 Estate Planning Teleconference Series* (Cannon Financial Institute December 5, 2006), at 12.

statutes, although Texas does not.<sup>83</sup> Both the Restatement 3d<sup>84</sup> and the UTC<sup>85</sup> grant authority to a “third party” to modify a trust. That third party, the trust protector, is “presumed to be held in a fiduciary capacity.”<sup>86</sup>

Serious thought should be given before granting extremely broad powers to the trust protector. The granting of such powers may increase the administrative burden for the trustee and lead to increased costs.<sup>87</sup> In the worst case, it could lead to legal conflicts between the trustee and the trust protector. If practical, the trust protector should be given the power to remove and replace the trustee. Additionally, I give the trust protector the authority to amend the trust for the purposes of allowing the beneficiary to attain or maintain public benefits in the event of changes in the law. The trust protector should have the authority to change the situs of the trust if it becomes necessary. Finally, I give the trust protector the right to terminate the trust if all else fails and the trust will disqualify the beneficiary from the receiving public benefits to which he would otherwise be entitled.

#### H. Funding the Trust

**6.01 Schedule of Assets. This Trust is hereby funded by the Grantor in the initial amount of Ten Dollars (\$10.00). Certain additional assets of the Trust may originate from lifetime or testamentary gifts of the Grantor or from any other party, whether by Will or beneficiary designation. The Executor or other personal representative of any such donor’s estate shall cause any testamentary assets so designated to be registered or titled in the name of the Trustee for the benefit of this Trust. All property held by the Trustee shall constitute the "Trust Estate."**

**6.02 Additions to Trust. Additions may be made to the Trust corpus from time to time by any person, except as limited in Section 6.03 below, provided that any such contribution or addition is accepted by the Trustee. Any additional transfer of property to this Trust shall be absolute; provided, however, that the duties of the Trustee shall not be increased by virtue of any such transfer without the consent of the Trustee.**

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<sup>83</sup> Alaska, Wyoming, South Dakota, Delaware, New Hampshire and Idaho.

<sup>84</sup> Restatement 3d, §64.

<sup>85</sup> UTC, §808(b) - (d).

<sup>86</sup> Restatement 3d, §64(2).

<sup>87</sup> Bove, “Trust Protectors” *Trusts & Estates* (November 2005) at 28.

**6.03 No Assets of Beneficiary Included in Trust. No assets owned by the beneficiary, or in which the beneficiary has any ownership interest, shall be accepted by the Trustee to be added to this Trust. No assets owned by the Beneficiary may be added to, or owned by this Trust in any manner.**

In the section on “funding” the trust, I specifically describe the origination of the assets which will now, or may in the future, come into the trust. This clearly identifies the trust as a Third-Party SNT. Additionally, I prohibit the trustee from accepting any assets owned by the beneficiary for inclusion into the trust. Since this is the section which will define the trust as “third-party” as opposed to “self-settled,” I spell out the prohibition against including assets of the beneficiary in very clear and unambiguous terms.

I. Trust Administration: Distribution Standard Defined

**7.01 Discretionary Distributions Defined. The Trustee may pay for the benefit of the Beneficiary, such sums of income and principal as the Trustee in his or his sole, absolute, complete, and unfettered discretion, shall determine, from time to time, are necessary or appropriate for the care, needs and comfort of the Beneficiary, defined as “special needs” herein. It is the intent of the Grantor that this Trust shall create a fund which shall be used by the Trustee for the sole benefit of the Beneficiary during his lifetime to supplement and not to supplant income from public benefits to which the Beneficiary may be entitled. This Trust is not intended to provide the primary support of the Beneficiary. It is intended that distributions from this Trust shall enhance the quality of life of the Beneficiary. The decisions of the Trustee in this regard are final. During the lifetime of the Beneficiary, the Trustee may distribute from the principal or income, or both, of this Trust, such amounts that, in the Trustee's sole and unfettered discretion, may from time to time be deemed reasonable or advisable. The Trustee may act unreasonably and arbitrarily, as I would do myself if I were living and in control of these funds. The Trustee's discretion in making a disbursement as provided for in this instrument is final as to all interested parties, even if the Trustee elects to make no disbursement at all. No court or any other persons should substitute its or their judgment for the discretionary decision or decisions of the Trustee. Any income of the Trust not so distributed shall be added annually to principal. The Trustee may provide income in-kind from the Trust pursuant to its specific distribution provisions in order to provide for the special needs of the Beneficiary by furnishing those items of need not provided by government entitlements. Under no circumstances shall the Beneficiary receive a share of the trust estate or accumulated income as a direct distribution from the Trust.**

In my section on trustee distributions, I described several relevant factors:

1. This is a discretionary trust;
2. The trustee has unlimited discretion in making distribution decisions;
3. There is no “support” standard; thus, this is not a support trust;
4. The intent of the grantor that this trust is intended to supplement and not supplant public benefits to which the beneficiary is entitled;
5. The trustee may act unreasonably or do anything the grantor could do;
6. The trustee may withhold distributions;
7. No court shall substitute their judgment for that of the trustee;
8. The trustee may make distributions for in-kind support and maintenance;
9. The beneficiary shall not receive a direct distribution from the trust.

I repeat a number of things throughout my trust, especially with regard to the grantor’s intent, distributions and the trustee’s discretion. I think it was Clifton Kruse who said, “If you say it enough times, the court might believe that you meant it.”

J. Trust Administration: Trustee’s Discretion Defined

**7.02 “Trustee’s Discretion” Defined. The Trustee shall have the authority to determine when a distribution from the Trust shall, or shall not, be made. The Trustee is under no compulsion to make any distributions whatsoever. When the Trustee determines that it is in the best interests of the Beneficiary, the Trustee shall make those distributions which the Trustee deems necessary, in the Trustee’s complete discretion. There is to be no standard to limit the discretion of the Trustee in making distributions or refusing to make distributions other than the overall liberal determination of reasonable best interests of the Beneficiary. No individual, entity nor governmental agency is authorized to compel a distribution from this Trust for any purpose.**

**7.03 Considerations in Making Distributions. In making distributions from this Trust, the Trustee is authorized to consider, in the Trustee’s sole discretion, the reasonableness or advisability of making distributions in satisfaction of the Beneficiary’s special needs. As used in this instrument, “special needs” refers to (in addition to other definitions set out herein) the requisites for maintaining the Beneficiary’s good health, safety, and welfare when, in the discretion of the Trustee, such requisites are not being provided by any government agency, office, or department; nonprofit organizations; or any other public or private source. Although the Trustee is authorized to consider these other sources and, where appropriate and to the extent possible, endeavor to maximize the collection of such benefits and to facilitate distribution of such benefits for the benefit of the Beneficiary, the Trustee may also, in**

**the exercise of the Trustee's discretion, disregard these other sources when making distributions to or for the benefit of the Beneficiary. Distributions may be made from the Trust Estate without securing prior court approval. It is the intention of the Grantor to create a special and/or emergency fund for the benefit of the Beneficiary and not to displace or supplant public assistance or other sources of support that may otherwise be available to the Beneficiary. It is important to the Grantor that the Beneficiary maintain a level of human dignity and humane care. The Trustee should bear this in mind when making distributions from the Trust while simultaneously considering that the Trust is not to be invaded by creditors, subjected to any liens or encumbrances, or administered in such a way as to cause public benefits to be not initiated or to be terminated.**

This section is more repetition intended to stress the unlimited discretion given to the trustee in making determinations as to the “best interests” of the beneficiary. It also clearly states that no governmental agency is authorized to compel a distribution from the trust.

In Section 7.03, I say what “special needs” refers to in determining what may constitute appropriate distributions for the best interests of the beneficiary. The specific examples of “special needs” is located in the definitions section at the end of the trust, although it would certainly be appropriate to add that list in this section.

K. Preferences With Regard to Beneficiaries

**7.04 Preference in Distributions. To the extent reasonable or advisable, the Trustee may deplete the Trust corpus prior to the Beneficiary's death, thereby giving preference to the interests of the Beneficiary while simultaneously considering the interests of the remainder beneficiary or beneficiaries. In considering the interests of the remainder beneficiary or beneficiaries, the Trustee is admonished to refrain from distributing property of the Trust to or on behalf of the Beneficiary that will then be retitled in the name of the Beneficiary. The Trustee shall hold title to all property comprising the Trust even when that property is distributed to the Beneficiary for his or her use. The Trustee may liquidate property of the Trust at any time, and such property need not be held in the name of the Beneficiary. No part of the Trust shall be used to supplant or replace benefits due from any insurance carrier under any insurance policy covering the Beneficiary.**

**7.05 Final Expenses of Beneficiary. Prior to the death of the Beneficiary, the Trustee shall give special consideration to paying any outstanding expenses of administration related to the Trust, including reasonable attorneys' fees, and should further consider purchasing a reasonable**

**burial plan to pay expenses relating to the funeral of the Beneficiary.**

This section states the grantor's intent that the trustee give preference to distributions for the lifetime beneficiary over the interests of the remainder beneficiaries. The trustee is admonished to refrain from titling any trust assets in the name of the lifetime beneficiary, since to do so would result in those assets passing through the beneficiary's estate, rather than to the remainder beneficiaries under the terms of the trust.

In Section 7.05, I state that final expenses, including a pre-paid burial plan, is an appropriate distribution for consideration by the trustee.

**L. Trust Administration: Matters Involving Public Benefits**

**7.06 Public or Private Assistance. The Beneficiary may be the recipient of public or private assistance programs. It is the Grantor's intent, but not as a directive, that no distributions of any kind be made, nor any other action taken, which will disqualify the Beneficiary from receiving such benefits or assistance, whether the Beneficiary is a current recipient, or a prospective recipient, of such benefits. The Grantor intends that the Trust fund supplement rather than supplant, impair, or diminish government entitlements. Distributions shall be limited so that the Beneficiary is not disqualified from receiving public benefits to which he is otherwise entitled, and this Trust shall be administered so as to supplement not supplant such benefits.**

**7.07 In-Kind Support and Maintenance. It is the intention that the Trustee provide income in-kind from this Trust, including in-kind support and maintenance, if such distributions are necessary, in the sole discretion of the Trustee. The Trustee may make distributions that would reduce public benefits without terminating the Beneficiary's eligibility for such benefits. The Trustee may make a distribution that would be considered income to a Beneficiary eligible for benefits under the Supplemental Security Income program that would result in a reduction of benefits to the Beneficiary under the "Presumed Maximum Value Rule" or the "One-third Reduction Rule" so long as such distribution will not cause the Beneficiary to be disqualified from the program.**

In these sections, I discuss in more detail the grantor's intent with regard to the circumstances of the beneficiary and the beneficiary's reliance upon public benefit programs. The trustee is prohibited from making distributions which would disqualify the beneficiary from receiving those benefits. However, it is important to allow distributions for in-kind support and maintenance. This

is specifically discussed, and the terms defined, in Section 7.07.

M. Trust Administration: Contingent Trusts for Remainder Beneficiaries

In order to anticipate issues which might arise with the remainder beneficiaries, I add to “contingent trusts” to avoid two of the most common problems. Since it is very possible to have a minor remainder beneficiary, I include a traditional “under 25” trust to manage assets for any such youthful remainderman. Considering that it is possible for that share to be reasonably large, or to grow substantially, I allow the remainder beneficiary the option to continue the trust beyond age 25 and to assume the duties of trustee for asset protection purposes.

In keeping with my duty as a disability planner, I feel that I would be negligent if I did not provide for the potential disabled remainder beneficiary. Therefore, I provide a contingent disability trust – a Third-Party SNT – for any remainder beneficiary who might be adversely affected by a direct inheritance.

N. Trust Administration: Matters Involving Specific Administration Issues

**10.03 Spendthrift Provisions. This Trust is a “Spendthrift Trust” as that term is defined by Texas law. None of the principal nor income of the Trust Estate, nor any interest in the Trust whatsoever may be anticipated, assigned, encumbered, nor be made subject to any creditor claims, nor to any legal process.**

**10.08 Authority to Amend or Terminate Trust. It is of primary importance that the corpus of this Trust shall not be considered to be an “available resource” to the Beneficiary which will disqualify the Beneficiary from receiving Public Assistance Benefits, or diminish such qualification in any manner. If the existence of this Trust, or any provision set forth in this Trust, adversely affects the Beneficiary from receiving such public entitlements or private support benefits; and if for any reason, the Trust Protector is unable to take the actions described in Section 5.03 above, then the trustee may take appropriate action...**

**10.09 No “Good Faith” Standard. For purposes of judicial review, the trustee shall not be required to exercise good faith in making his or his determination of distributions in the best interest of the Beneficiary.**

**10.12 Fiduciary Compensation. Any trustee and Trust Protector shall be entitled, without court approval, to reasonable compensation commensurate with the services actually performed and to reimbursement for expenses properly incurred. Any corporate fiduciary acting hereunder shall be compensated at the rates from time to time specified in its published schedule of fees.**

While some of the matters address in this section are relatively standard, a few are worthy of discussion. Section 10.03 identifies this trust a spendthrift trust. Although some experts in the field of trusts believe that a purely discretionary trust should not need a spendthrift clause, the problems which appear to be on the horizon with regard to the differences between support trusts and discretionary trusts – or rather the elimination of such differences – leads me to the conclusion that there is no excuse for not including a spendthrift clause in every trust.

I have previously given the trust protector the authority to amend the trust in order to attain or maintain public benefits for the beneficiary in the event of a law change. In order to give the maximum flexibility in the trust, I now give the same authority to the trustee in the event that there is no trust protector serving, or if the necessary action is not taken by the trust protector.

I understand that the NEW Texas Trust Code does not allow the grantor to waive the duty of “good faith.” However, to show my displeasure with the Texas legislature for such a mindless act in modifying generations of Texas law without any understanding of what they were doing, I have included this section. It is intended to keep the judicial standard of review as high as possible for a purely discretionary trust – i.e. eliminating the beneficiary from automatically having the standing to bring a suit against the trustee to require distributions on the grounds that the trustee has breached his duty of “good faith” by withholding distributions.

Every trust must address the issue of fiduciary compensation. This is especially true if a corporate trustee may be utilized at some point.

O. Trust Administration: Choice of Laws

**12.03 Texas Law Applies. This Trust Agreement has been executed in the state of Texas. All questions pertaining to its validity, construction and administration shall be determined in accordance with the laws of the State of Texas. If it becomes necessary to apply the laws of any other jurisdiction to the administration of this Trust in order to obtain or maintain public benefits for a beneficiary, then the trustee is authorized to amend the terms of this trust in order that such public benefits may be obtained or maintained. The determination of the trustee with regard to this section shall be conclusive.**

**12.04 Texas Trust Code. The provisions of the *Texas Trust Code* shall apply to any trust created and administered under this Trust Agreement to the extent that such provisions do not conflict with the terms or purposes of the trusts created hereunder. To the extent that any such conflict shall arise, the terms of this Trust shall control.**

**12.05 Applicability of the Uniform Trust Code. Irrespective of whether or not the state of the beneficiary’s residence has adopted the *Uniform Trust Code*, the provisions of the *Uniform Trust Code* shall not apply to this Trust.**

**12.06 Applicability of Specific Texas Trust Code Chapters. Chapter 116 (*Uniform Principal and Income Act*) and Chapter 117 (*Uniform Prudent Investor Act*) of the *Texas Trust Code* shall be advisory only and shall not be binding with regard to any matter involving this Trust.**

I go out of my way to stress choice of laws in my trusts. I feel that Texas trust law is superior to other states, the *Restatement 3d* and the *Uniform Trust Code*. Since I don't want the provisions of any other jurisdiction, nor the *Restatement*, nor the *UTC* to apply, I say so in very unambiguous language. I understand that my language may not be controlling in another jurisdiction, but it doesn't hurt to state your preferences.

In Section 12.05, I generally adopt the provisions of the *Texas Trust Code*, except to the extent that the terms of the Code conflict with the express terms of this trust or the intent of the grantor.

In Section 12.06, I make the provisions of the *Uniform Principal and Income Act* (*Texas Trust Code*, Chapter 116) and the *Uniform Prudent Investor Act* (*Texas Trust Code*, Chapter 117) advisory only, rather than mandatory, on the trustee. If these waivers are not included, I believe that the provisions of both Acts are mandatory.

P. Optional Provisions for Particular Circumstances

1. Classifying the Trust: Is this a Crummey Trust?

**10.17 Withdrawal Rights for Additions to Trust. With regard to any gifts made to the Trust by any person during the donee's lifetime, but not as a result of death or inheritance of the donee, the following provisions shall apply with regard to remainder beneficiaries only:**

**A. In the calendar year of establishment of this Trust and in any calendar year during which additional property is transferred to this Trust whereby any transferor or such transferor's spouse has made or is deemed to have made a gift (but not by reason of gift-splitting alone), the remainderman, but not the Beneficiary, of this Trust shall have the power, commencing with the date of the creation of this Trust or the date of such additional transfer, as the case may be, to withdraw property from the Trust, including the property transferred.**

If the grantor elects to fund the trust with annual exclusion gifts for estate tax purposes, it is necessary to make the trust a "Crummey Trust" by adding withdrawal rights which will apply to the

gifts. Without the withdrawal rights, the annual gifts are classified as “incomplete gifts” which do not qualify for the annual gift tax exclusion (currently \$12,000 per donee per calendar year). For more on this subject, refer to Section XIV above.

2. Classifying the Trust: Is this a Grantor Trust for Income Tax Purposes?

**6.04 Right to Substitute Property. Grantor reserves the right to reacquire trust property by substitution of other property of equivalent value, in accordance with IRC § 675(4)(C). It is the intent of the Grantor that the Trust be treated as a Grantor Trust for federal income tax purposes pursuant to IRC § 675(4)(C); and it is the intent of the Grantor that no portion of this Trust be includable in the gross estate of the Grantor or of the Grantor's spouse for estate-tax purposes, and, accordingly, the Grantor directs that this Agreement shall be construed and the Trust hereunder administered in accordance with and to carry out that intent.**

If the grantor elects to be treated as the owner of the trust for income tax purposes, certain rights with regard to the trust assets must be retained. The language in Section 6.04 is often used to accomplish this objective. For further discussion, see Section XIV above.

3. Classifying the Trust: Will the Trust Own Insurance?

**11.05 Additional Powers. In addition to such powers, the trustee is specifically authorized as follows:**

**A. The trustee shall have all powers, authorities, and discretions granted by common law or statute so as to confer the broadest possible powers available. In addition, the trustee is expressly authorized and empowered, in the Trustee's sole and absolute discretion, to exercise the powers set forth below:**

**(12) Life Insurance. The trustee may purchase life insurance on the life of any individual in which any beneficiary hereunder may have an insurable interest; may enter into any form of split-dollar arrangement with respect to such insurance, including a split-dollar arrangement with another trust of which any trustee hereunder is acting as a trustee, notwithstanding that such arrangement may constitute an act of self-dealing; may pay any premiums on any such life-insurance policy held hereunder from trust income and/or principal; may exercise with respect to said insurance policies held hereunder, from time to time, all options, rights, elections, and privileges**

**exercisable with respect to said policies, including, but not limited to, the right to demand and collect from the company or companies issuing said policies all such proceeds as shall be payable to the trustee; may designate and change the beneficiaries thereunder, provided, however, that neither the Grantor nor the Grantor's spouse may be designated as such beneficiary; may modify, exchange, surrender, or cancel any such policies of insurance; may borrow on and pledge any such policy in connection with a loan; may assign and distribute any and all of the rights thereunder to or for the benefit of any beneficiary of the trust; may direct the disposition of dividends or surplus; may convert said policies into different forms of insurance; and may elect methods of settlement with respect thereto.**

The purchase of life insurance as a trust asset is not often addressed. However, if it is an option that the grantor wants to leave open, then the terms controlling how that is accomplished should be included. It is important that the proceeds from the policy be excluded from the gross estate of the grantor for federal estate tax purposes.

## XV. DRAFTING DISASTERS

The most obvious distinction between the Third-Party SNT and the Self-Settled d4a SNT is that the d4A SNT requires a “Payback” provision, while the Third-Party SNT does not. The importance of this issue cannot be overstated.

### A. Self-Settled SNT

The Self-Settled SNT must include a provision to pay remaining funds to the state Medicaid agency at the death of the beneficiary up to the amount paid by that agency for the benefit of the trust beneficiary. The payback provision must comply with state law and be acceptable to the Medicaid agency before the trust will be approved as an unavailable, non-countable resource. Without this provision, the trust will not be approved and the beneficiary will not be eligible for benefits.

### B. Third-Party SNT

The Third-Party SNT must not include a payback provision. To do so is malpractice on the part of the drafting attorney. There have been cases where a Third-Party SNT contained a payback provision. Even though the state Medicaid agency was not otherwise entitled to be paid back for Medicaid benefits paid on behalf of the trust beneficiary, since the terms of the trust required that the state agency be reimbursed, the agency demanded reimbursement and prevailed. This drafting

error cost the remainder beneficiaries much of their inheritance. Accordingly, it is not harmless error to use a d4A trust form to implement a Third-Party SNT. The payback provision must not be included in the trust.

## XVI. CONCLUSION

Special Needs Trust planning is not a forms practice. While many practitioners stress that the actual administration of a SNT is the more difficult side of the equation, the attorney called upon to properly draft the trust must be familiar with the issues discussed in this article so that (1) the beneficiary will be able to obtain or maintain public benefits; (2) the trustee will have the discretion and flexibility to properly administer the trust in the best interests of the beneficiary; and (3) the trust document has been drafted to reflect and obtain the desired tax consequences in order to avoid surprising adverse tax allocations.