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A Guide To Special Needs Trusts

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Published 4/20/2009

Much has changed since advisors first began assisting clients with special needs planning. Today, childhood disabilities are diagnosed earlier and more accurately, infant mortality has decreased, and life expectancies of the disabled have increased. Additionally, the definition of disability has expanded to include individuals who have issues that in the past may not have been identified or served in the estate planning process.



The definition now includes individuals who lack functionality due to drug addiction and those with late or adult onset of conditions such as mental illness and trauma or injury from accidents. In addition, improved drug therapies are allowing many people to live longer with chronic illnesses such as HIV/AIDS, cancer or chronic fatigue syndrome. By expanding the pool of clients they consider appropriate for discussions about special needs trusts (SNTs), advisors can maximize their value to clients and their loved ones.

Critical role of the special needs trust

Under current federal law, assets in excess of \$2,000—with certain exceptions—disqualify an individual with special needs from most federal and state needs-based assistance, such as supplemental security income (SSI) and Medicaid. Government programs provide benefits for basic care, which includes crucial services such as comprehensive health insurance, prescription coverage, attendant services, dental coverage, day rehabilitation programs and group homes. People with disabilities who receive publicly funded services must contribute toward the cost of their care on a sliding scale, and are usually allowed a small personal care allowance (which is often subsidized by family members if it is not sufficient to meet the disabled person's needs).

A SNT uses the trust's assets to provide benefits that supplement the disabled beneficiary's care. The trustee is not authorized to replace the cost of services covered by government-sponsored programs and may only provide funds

for certain supplemental expenses not covered by SSI and Medicaid.

Financial planning provides protection and access to quality care

Careful financial planning allows a parent or spouse of the disabled individual to provide help in purchasing the extras—such as travel, computers, higher quality medical and dental care, education, and rehabilitation—without exposing his or her loved one to cost-of-care charges after the parent or spouse dies or can no longer provide care.

When creating a SNT, coordination between public and private funding is necessary to provide a reasonably comfortable lifestyle for the disabled family member. It is essential to obtain the services of an attorney who is conversant not just in estate planning, but also in special needs planning, disability laws, entitlement programs and elder law.

While the SNT must be carefully drafted, it is equally important to select the correct type of trust: third-party, individual or pooled.

Third-party special needs trust

The most common type is the third-party SNT. It is usually created by a primary caretaker, such as a parent or grandparent, but can be created by anyone, such as a friend of the disabled individual. The trust is drafted to give the trustee complete discretion to make distributions for expenses not already covered by government benefits. By creation of the trust, a fund exists to help maintain the beneficiary's quality of life and pay for personal care needs that government benefits do not provide. This eliminates the need for handouts from relatives and preserves the beneficiary's eligibility for government benefits.

There are rules that third-party SNTs must follow. The person with the disability is not able to contribute assets to his or her own trust, and cannot serve as trustee, or successor trustee, over the trust. Provisions should be included to protect the trust against creditors or government agencies trying to recover funds. Lastly, the grantors should select a remainder benefici-

ary for the trust assets after the individual with the disability dies.

Due to the cost of retaining an attorney to draft a trust customized to the individual needs of the disabled beneficiary, most third-party SNTs are created by high-net-worth clients who can pay for the costs of establishing and funding the trusts. Such trusts can be funded during life of the primary caretaker or at his or her death.

Individual SNTs (also called “Self-Settled Special Needs Trusts”)

The Omnibus Budget Reconciliation Act of 1993 (OBRA '93) changed the Medicaid rules pertaining to asset transfers. Under OBRA '93, a person cannot qualify for Medicaid if he or she transfers assets to another person within 36 months of applying for Medicaid. This “look-back period” is extended to 60 months for transfers to most trusts. This means that a Medicaid applicant will have to spend down his or her assets to \$2,000, or wait 36 months from the date the excess assets are transferred, in order to apply for Medicaid benefits.

Fortunately, the law also stipulates an exception to help individuals who meet the Social Security Administration's definition of totally and permanently disabled. This exception allows a disabled individual, under age 65, to remain eligible for Medicaid after a transfer of his or her assets to an irrevocable self-settled trust. The trust must be established by a parent, grandparent, guardian or the court.

Thus, even if the disabled person is a competent adult, he or she must ask a qualified party or go to the court to seek establishment of the trust. Only the disabled individual's assets may be transferred to the trust. This trust is also considered a payback trust because OBRA '93 requires that if there are assets remaining in the trust when the beneficiary dies, the state is entitled to be repaid the full amount that Medicaid paid on behalf of the beneficiary.

Although the payback feature may seem detrimental, self-settled trusts are helpful for disabled individuals who already own assets, such as from a legal settlement or payout from an accident or malpractice suit. Another common instance arises when parents attempt to help a disabled loved one by leaving their entire estate directly to the beneficiary or by creating a uniform transfer to minors account. Families place funds in a UTMA because they want to set aside as much money as possible to ensure the disabled person has sufficient funds available to maintain the quality of life to which he or she is accustomed. While this is one way to pass assets to children gift tax-free, it may disqualify a disabled child from government assistance.

Pooled special needs trust

The third type of SNT is the pooled SNT. Federal law

requires pooled SNTs to be established and managed by non-profit entities. The charity administers the trust and can make it available to a limited pool (such as the charity's regional members) or an open pool, for anyone who qualifies to establish an SNT and meets the Social Security Administration definition of totally and permanently disabled.

Trust assets are pooled for investment purposes, although each client has his or her own separate account credited with a share of the pool's investment return. Pooled SNTs often operate in a turn-key manner, with standardized investment procedures with a financial investment firm, and master trust documents with a corporate trustee.

Additionally, they have a network of qualified attorneys who specialize in the special needs estate planning field. This all-inclusive approach to establishing a SNT works well for middle to lower income clients who often are underserved by planning professionals, cannot afford high attorney fees and may have no need for a customized trust.

A *third-party* pooled SNT can be created by anyone, such as a parent, primary caretaker or sibling. An *individual* pooled SNT can be created by the disabled individual. Both types of pooled SNTs preserve the eligibility of the disabled person for public benefits. Like a self-settled SNT, an individual pooled SNT is a payback trust. If there are assets remaining after the government has been reimbursed, the disabled individual may provide for distribution to his or her family or a charity. For third-party pooled SNTs, no payback to the government is required and the grantors designate a remainder beneficiary for after the beneficiary's death.

Funding the trust: life insurance is key

All SNTs can be funded—much like any other trust—with a wide range of assets, including cash, stock, personal property and real estate. However, many families often have few, if any, assets to fund a trust. Thus, life insurance may be the *most* critical component in funding third-party or pooled SNTs for disabled dependents.

Life insurance has many compelling features that make it an ideal asset in a SNT. If life insurance is chosen as the means to fund an inheritance to a disabled dependent, a “self-completing” feature is accomplished. Full life insurance proceeds are paid out at the time the insured dies, regardless of whether premiums have been paid for one year or 20.

Unlike other investments, insurance proceeds do not need to grow. Even if something should happen during life, such as the incapacity of the parent, the trustee may be able to access the cash value in a permanent life insurance policy through withdrawals or loans.

While many concerned parents want to leave all their

assets to a disabled dependent, they are likely to have their worth tied up in illiquid assets such as a home, personal property, real estate or other investments—most of which will be difficult for the disabled individual to manage. Guardians and trustees selected for such a dependent are often chosen for their caretaking and organizational abilities, not financial management skills. By leaving the proceeds of a life insurance policy for the benefit of a disabled dependent and all other estate assets to the care of the non-disabled-children, the chosen guardian and trustee have immediate access to liquid assets to take care of the disabled individual's needs without the additional burden of managing illiquid assets.

Expenses for a disabled loved one can be difficult to predict and estimate. Life insurance offers the ability to leverage the gifts made via premiums to provide the maximum amount possible to the disabled beneficiary as an inheritance. Because the internal rate of return on life insurance is often very compelling, especially in the early years of a policy, it usually offers a means to leverage the amount of the devise.

The death benefit is generally federal income tax-free, and if the policy is purchased inside of an irrevocable SNT, the

policy proceeds avoid both the probate process and federal estate taxation to which the insured's estate is subject. If the primary caretakers are a married couple, then a survivorship policy would work best to provide a payout after the death of the second spouse.

Comprehensive support maximizes benefits

Through the use of a SNT funded with life insurance, there are many options to help clients with loved ones who have special needs. The team of qualified advisors should include an attorney who has experience in setting up these vehicles, a life insurance agent who understands different life insurance products and how they can help maximize the assets used to fund the trust, and a representative of the state-sponsored benefit programs to ensure that the clients understand their options and the associated costs. Fortunately for families touched by disability, the synergies and expertise of advisors have kept pace with the ever-increasing pool of potential clients in need of SNTs.

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