



TWO DIFFERENT KINDS OF SPECIAL NEEDS TRUSTS

There are two kinds of Special Needs Trusts (“SNT”):

TO DETERMINE WHICH KIND, ASK WHOSE MONEY (property) IS IT?

1. Third Party

This is the most common type of SNT and it is funded with assets belonging to someone other than the beneficiary. Typically, parents of the disabled individual establish these trusts, although a grandparent, a sibling or another third party may also establish them. These trusts can be drafted as a part of a will, a living trust or as a stand-alone document. They are usually funded upon the death of the parents, although a stand-alone document could be used to receive gifts from several donors so that the funds are consolidated into one entity.

This type of trust does not have to be irrevocable in order to preserve a beneficiary’s public benefits. However, it cannot be revocable by the public benefits beneficiary, or the trust assets would be considered as an available resource for SSI and Medi-Cal purposes. If the third party Special Needs Trust is revocable, the Settlor still has the ability to amend the trust if there are changes in the law or the circumstances of the beneficiary. It can also allow the Settlor to test the validity of the trust, because if a public agency challenges it, it can still be amended or even revoked.

The most important difference between this type of trust and the self-settled SNT (as explained below) is that there is no requirement to reimburse Medi-Cal for the public benefits received from the assets remaining in the trust when the beneficiary dies. As a result, this type of trust does not receive the same level of scrutiny by Medi-Cal that the self-settled SNT does.

2. Self-Settled

42 U.S.C. § 1396p(d)(4)(A)

These trusts are also called first-party special needs trusts, litigation special needs trusts, and Medi-Cal payback trusts.

This type of trust is established by an individual who is under 65 years of age with his/her own funds and for his/her own benefit. These trusts are used when the person with a disability has inherited money, or received a court-settlement. The trust has to specify that after the disabled person has died, all amounts remaining in the trust, up to an amount equal to the total medical assistance paid on behalf of the individual under Medi-Cal, are repaid to Medi-Cal.

Trusts which are created with proceeds from a lawsuit are often called Litigation Special Needs Trusts (LSNTs), which must be established through the court. To obtain court approval for the establishment of the trust, a petition must be brought by the guardian, conservator, or any interested person [Probate Code § 3602(d)]. The proper court for hearing the petition is the court approving the settlement or giving judgment in the underlying proceeding. After the trust is approved, the court may transfer continuing jurisdiction to the probate court in the county where the principal administration of the trust will occur.

In order to establish a Special Needs Trust that is considered “exempt” in determining public benefits eligibility, Probate Code § 3604 requires that the court make the following specific findings:

1) That the minor or incompetent person has a disability that substantially impairs the person’s ability to provide for his or her own care or custody and constitutes a substantial handicap [Probate Code § 3604(b)(1)];

2) That the minor or incompetent person is likely to have special needs that will not be met without the trust [Probate Code § 3604(b)(2)]; and

3) That the money to be paid to the trust does not exceed the amount that appears reasonably necessary to meet the special needs of the minor or incompetent person. [Probate Code § 3604(b)(3)].

In practice, a person who qualifies for SSI or Medi-Cal on the basis of disability is likely to satisfy the substantial impairment requirement for Probate Code § 3604(b)(1). Although the Probate Code refers to minors or incompetents, references to an “incompetent person” are deemed to include “a person for whom a conservator may be appointed” [Probate Code §3603]. In most instances, a person who has satisfied the federal standard and is receiving SSI and Medi-Cal is also a person “for whom a conservator may be appointed...” A conservator may be appointed for a person who voluntarily requests the appointment such as when a person is mentally competent but suffering from a physical impairment. [Probate Code 3603]

3. Pooled Trusts

42 U.S.C. §1396p(d)(4)(c)

Pooled Trusts can be used for both self-settled and third party Special Needs Trusts. This type of trust is established through a non-profit association who administers the trust as part of a pool of trusts during the lifetime of the beneficiary.

1) The trust is established and managed by a non-profit association.

2) A separate account is maintained for each beneficiary of the trust, but, for purposes of investment and management of funds, the trust pools these accounts.

3) Accounts in the trust are established solely for the benefit of disabled individuals by the parent, grandparent, or legal guardian of such individuals, by such individual beneficiary, or by a court.

4) To the extent that amounts remaining in the beneficiary's account upon the death of the beneficiary are not retained by the trust, the trust pays to the state from such remaining amounts in the account an amount equal to the total amount of medical assistance paid on behalf of the beneficiary under the state plan under this title.

Pooled trusts are useful for small inheritances or settlements, when there is no appropriate trustee, and for individuals over 65 years of age.

San Diego Special Needs Trust Foundation (619-338-4477)

**What are the differences between the two kinds of Trusts for
income tax purposes?**

A SNT should have its own Employer Identification Number (EIN) and the trustee should file annual state and federal fiduciary income tax returns. Although a self-settled SNT does not have to have its own EIN, it is recommended that the trustee do so.

1. Third Party

These trusts are usually “complex” trusts for Internal Revenue Code purposes. A complex trust is not a grantor trust and the trust instrument cannot require distribution of all income to the beneficiary. Therefore, income is taxable to the beneficiary only to the extent that it was actually distributed on behalf of the beneficiary. These distributions of income for the beneficiary will be shown on a K-1 form that is sent to the beneficiary and reported under the beneficiary’s social security number.

2. Self-Settled

These types of trusts are usually considered to be “grantor” trusts for Internal Revenue Code purposes. Therefore, the income which is generated by this trust can be taxed to the grantor, whether it is actually distributed to the grantor or not; and can be reported on the grantor’s income tax return.

Usually, the trust, under its own EIN, will receive the 1099's from financial institutions. The Trustee can keep track of income that is reported to the Internal Revenue Service and be able to demonstrate to any interested public agencies that this income was not disqualifying income for the

beneficiary. The Trustee should see that the beneficiary's personal income tax return is prepared and the SNT can pay for the preparation and any personal income tax due by the beneficiary. Since trusts reach the highest marginal rate for income at only \$7,500.00, it is usually beneficial to have the income "passed through" to the beneficiary as the grantor of the trust because individuals do not reach the highest marginal rate until income exceeds \$250,000.00. However, one benefit of having the income taxed in the SNT is the administration expenses can be deducted from income without having to reach the two percent floor required for individual taxpayers. This benefit is usually outweighed by the income tax benefit of having the income "passed through" to the beneficiary.

A special power of appointment is often included in the trust to insure treatment as a self-settled trust. This can be done even though the beneficiary is incapable of exercising the power. In addition, the power gives the beneficiary who has capacity, or may someday recover capacity, some authority over the trust remainder.

Please call our office at (858) 689-0613 if you would like to discuss what type of Special Needs Trust is appropriate for you or your client.