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Distribution Standards for the Special Needs Trust

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This author is indebted to NAELA member Renee Colwill Lovelace, CELA, who hosted an eight hour marathon discussion of SNT distribution drafting at the 2000 NAELA Institute.

A. Special Needs Trust Analysis

Elder law attorneys draft trusts for disabled beneficiaries every day, and the distribution standards for these trusts vary remarkably. The “distribution standard” of a special needs trust (SNT) is the focus of this article. The most common trust distribution standards in use at this time (May, 2001) are described, with comments on the effect of that standard on public program eligibility.

The practitioner answering the usual question from a client:

Will this trust “work” ?

Needs to begin the answer by looking at the distribution standard in the trust. The distribution standard will affect whether the trust “works” for the disabled beneficiary in two ways:

1. Too broad a distribution standard will, in some jurisdictions, cause the trust to be considered an available resource for some needs-based public benefit programs, disqualifying the beneficiary simply by the trust existence, whether or not distributions are actually made.
2. Too narrow a distribution standard restricts the trustee from enhancing the dignity and quality of life of the disabled beneficiary in the most effective manner.

Whether the distribution standard is too broad or narrow, the trustee may make distributions which in and of themselves might reduce one or more of the beneficiary’s needs-based public benefits. The trustee may operate any trust to produce countable income for the beneficiary, thus reducing income-based public benefits.

Needs-based public benefit programs are those which, like Medicaid and Supplemental Security Income (SSI), have strict income and resource eligibility requirements. No book or research collection defines all needs-based programs, then evaluates the impact of a SNT distribution standard or of a particular distribution on the needs-based programs. Creating that resource is beyond the scope of this article. Perhaps NAELA will precipitate that needed research, and then be the forum for its publication.

Self-settled trusts are evaluated differently, and more strictly, by public needs based program managers than trusts created by a third party, funded with a third party’s funds. This article does not deal, other than incidentally, with the self-settled/third party trust scrutiny problem. Further analysis of that interesting issue is also needed.

B. No National Definition of A Special Needs Trust

Federal statutes dealing with trusts and public benefits do not define a special needs trust or mandate a particular SNT distribution standard.¹ In its Program Operations Manual, the Social Security Administration (SSA) has declared: “A SNT has no special significance for SSA.”² For the

¹ 42 U.S.C. 1396p(d) (amended August 10, 1993, by the Revenue Reconciliation Act of 1993), and HR 3443, Foster Care Independence Act of 1999, 42 U.S.C. 1982b(e)(5).

² In a Program Operation Manual (POMS) section dealing with New York and New Jersey special needs

SSA, the crucial trust elements which prevent the trust, in and of itself, from being an available resource are as follows: if the trust is irrevocable, for the sole benefit of a SSI recipient, and has identifiable remainder (SSA uses the term “residual”) beneficiaries, then the trust itself is not an available disqualifying resource to the trust beneficiary.

Some states by statute have begun to define special needs trusts with particularity, and to suggest or mandate particular distribution language.

C. Disability-Blind Trusts

Trusts may be created without regard to the disability status of a beneficiary or possible public benefit eligibility. Such disability-blind trusts may, for example, mandate distribution of a percentage of corpus periodically, or of a particular set sum monthly or yearly. Such disability-blind trusts may require or permit distributions for “health, education, support and maintenance” - the HEMS standard commonly used by trust and estate practitioners.

Because neither the federal law nor most states define special needs trust distribution standards, trustees have in some instances operated disability-blind trusts (not drafted with disability and public programs in mind) like special needs trusts. Creative trustees make distributions designed to minimize the risk that a desirable public needs-based program will be lost.

D. Six Common Distribution Standards

The six most commonly used trust distribution standards, and the likely impact on needs-based public programs, are discussed below. NAELA members attending the Cynthia Barrett and Ruth Phelps’ “Basics of (d)(4)(A) Trusts” presentation at the 2001 Vancouver Symposium were polled about use of various SNT distribution standards, and the results reported below.

1. Mandatory support:

In disability-blind trusts, the most common distribution standard is the mandatory support standard:

My trustee shall distribute to or for the benefit of the beneficiary those amounts of income or principal which are necessary for his health, education, maintenance, and support.

trusts, the SSA describes a SNT as follows: “A SNT is a discretionary trust established to allow the supplemental needs of an individual with disabilities to be met with income of the trust. These trusts are frequently set up when the beneficiary turns age 18 and has previously had a guardianship or conservatorship account funded by a personal injury award. The language of the trust will show that: 1) the creator’s intent is to supplement and not supplant the beneficiary’s government benefits; 2) the trustee is prohibited from expending trust assets in way which may supplant the beneficiary’s government benefits; 3) the trustee is authorized to make distributions to third parties to meet the beneficiary’s needs for food, clothing, shelter or health care, if the beneficiary’s needs will be better met and it is in the beneficiary’s best interests to suffer the consequential effect on his eligibility for government benefits; and 4) the beneficiary does not have the power to authorize distributions from the trust. A SNT does not have special significance for SSA. POMS SI R01120.200 (A) (4).

The mandatory support standard trust, whether in third party trusts or self-settled trusts, will likely be challenged by public programs as an available resource, and is very likely to disqualify a disabled beneficiary from needs -based benefits. At the NAELA 2001 Symposium in Vancouver, British Columbia, none of the polled attendees at the Barrett/Phelps SNT presentation used the mandatory support distribution standard when drafting instruments for a disabled beneficiary with needs -based benefits.

2. Discretionary support:

A common distribution standard for a disability-blind trust is the fully discretionary support standard trust, permitting the trustee to distribute trust income or principal for support, but allowing full and complete discretion in choosing a particular distribution:

My trustee may distribute to or for the benefit of the beneficiary those amounts of income or principal which my trustee may determine, in my trustee's sole, absolute and unfettered discretion, are necessary for his health, education, maintenance, and support.

Most elder law attorneys have in their libraries the resource by Clifton B. Kruse Jr., **THIRD PARTY AND SELF CREATED TRUSTS**, 2nd edition, (American Bar Association 1998). In that work, Mr. Kruse reviews the reported court decisions on third party trusts and public benefits. Many of Mr. Kruse's collected cases turn on the exact wording of the trust distribution clause. Mr. Kruse commented on the discretionary support trust and concluded: "The discretionary support trust is therefore an unreliable vehicle by which settlors may provide for beneficiaries' expenses that the state does not pay or is otherwise obligated to pay." Kruse, supra, p. 37.

At the NAELA 2001 Symposium in Vancouver, British Columbia, none of the polled attendees at the Barrett/Phelps SNT presentation used the discretionary support distribution standard when drafting instruments for a disabled beneficiary with needs-based benefits.

3. Fully discretionary, no mention of special needs³:

The traditional trust and estate lawyer hoped that drafting a trust with a fully discretionary distribution standard, mentioning neither support nor special needs, would provide the trustee with the most flexibility in any situation encountered by the beneficiary. Fully discretionary third party trusts with a spendthrift clause would, under common law, (1) be unassailable by creditors of the beneficiary; and (2) the beneficiary himself or herself could not force the trustee to make a particular distribution.

The fully discretionary distribution standard might read:

My trustee may distribute to or for the benefit of the beneficiary those amounts of income or principal which my trustee may determine, in my trustee's sole, absolute and unfettered discretion, to be appropriate, and my trustee may choose to make no

distributions whatsoever.

Although the fully discretionary trust is preferred by some trustees, as it permits the trustee to alter distributions to meet a situation faced by a particular beneficiary, the corpus of a fully discretionary trust may be deemed an available resource in some states. For example, in Ohio, the state deems the entire corpus of a discretionary trust fully available to the disabled beneficiary, thus disqualifying him or her for benefits, whether or not any distribution is made. Ohio requires that the trust instrument clearly limit the distribution authority to supplemental services, as defined by its administrative rules. Ohio Rev Code §1339.51(D)(4) [2000]⁴

Although fully discretionary trusts should NOT be considered as an available resource, and could be operated as a special needs trust, the lawyer who wishes to venture into such drafting should review the cases cited by Clifton B. Kruse Jr., **THIRD PARTY AND SELF CREATED TRUSTS**, *supra*, p. 29-43.

At the NAELA 2001 Symposium in Vancouver, British Columbia, the attendees at the Barrett/Phelps SNT presentation were polled. Practitioners from Kansas, Alaska, Michigan, Wisconsin, and Connecticut reported using the fully discretionary trust standard when drafting instruments for a disabled beneficiary with needs-based benefits. The practitioners from Michigan, Wisconsin, and Connecticut expressed caution about the effectiveness of a fully discretionary distribution standard in a self-settled 42 U.S.C. 1396p(d)(4)(A) trust. A Florida practitioner reported that case law in his state permitted one fully discretionary trust, and disallowed another.

4. Fully Discretionary, precatory language⁵:

Some practitioners use the fully discretionary distribution standard, then add language explaining the intent of the grantor and the supplemental needs of the disabled person, such as the following example:

My trustee may distribute to or for the benefit of the beneficiary those amounts of income or principal which my trustee may determine, in my trustee's sole, absolute and unfettered discretion, to be appropriate, and my trustee may choose to make no distributions whatsoever.

My son is disabled, and will rely on public programs for much of his life. I will not

⁴Ohio Administrative Code 5122-22-01 (for trusts benefitting the mentally ill) and 5123-2-18-01 (for trusts benefitting those with other forms of disability) list particular distribution items, such as magazine subscriptions, membership in health clubs, counseling, and reimbursement for attendance at seminars or conferences.

⁵This discretionary precatory distribution language is likely to become the most common third party created trust SNT distribution standard, but is not the only SNT distribution standard used by experienced practitioners. In Ohio, a discretionary trust may be deemed a fully available resource. Ohio Rev Code §1339.51(D)(4) [2000] The Texas Department of Human Resources and Department of Mental Health and Mental Retardation wrote to the ARC of Texas and declared that fully discretionary special needs trusts would no longer be disqualifying in that state. H. Clyde Farrell *New Special Needs Trust Options from the ARC of Texas Pooled Trusts*. P. 3-4, Texas NAMI website, <http://texas.nami.org/Legal.html>

always be there to help him and oversee his care. I know that he will have supplemental and special requirements, including a need for advocacy, which will not be provided by the publicly funded programs. I urge my trustee to, in the exercise of his unfettered discretion, make distributions which permit my son dignity and grace, enhance my son's day to day existence, and allow him the highest possible development of his abilities.

Practitioners, by using this precatory language, hope to persuade a judge that the intent of the trustor should be followed, and that the trust should be permitted to supplement public benefit programs.

At the NAELA 2001 Symposium in Vancouver, British Columbia, many of the polled attendees at the Barrett/Phelps SNT presentation had used the “discretionary, with precatory language” distribution standard when drafting instruments for a disabled beneficiary with needs-based benefits. However, a practitioner from Ohio commented that this approach would not work in that state, because of its statute and administrative code may make the entire discretionary trust corpus available. Ohio Rev Code §1339.51(D)(4) [2000]

5. Strict⁶, prohibiting food, clothing, shelter:

Some special needs trusts prohibit distributions for food, shelter or clothing. This trust language is known as the “strict” SNT or an SSI SNT. In the Supplemental Security Income (SSI) program, giving the trust beneficiary new clothes or groceries, or paying rent, will reduce the program monthly check (after complex in-kind income rules are applied). The strict SNT trust distribution prohibition language may read as follows:

No part of the principal or income of this trust may be distributed for food, shelter or clothing, or to replace any public assistance benefits for which the beneficiary may be eligible through any governmental agency.

The trustee may supplement but not supplant the public benefits otherwise available to the disabled beneficiary.

Many early special needs trusts prohibited distributions for food, shelter and clothing, but practitioners and trustees grew to dislike the prohibition. Not all disabled beneficiaries receive SSI, and some beneficiaries might not be on needs based programs at all times. Trustees wanted to pay for food, clothing, and shelter when such items were not disqualifying.

Family members funding the strict SSI trusts often most wanted to pay for housing, and were upset that housing assistance was foreclosed by the strict prohibition. If the trustee inadvertently paid for items later disallowed by program managers, the trustee feared exposure to negligence or breach of fiduciary duty claims for violating the strict prohibition.

At the NAELA 2001 Symposium in Vancouver, British Columbia, about ten percent of the

⁶ The strict SSI standard for distributions is very common, but has come to seem too restrictive in situations where the beneficiary is not receiving SSI, and is eligible for other programs with more liberal eligibility standards. Experienced practitioners still draft SNTs with these strict distribution standards in some self-settled trust circumstances, and as an alternate receptacle trust in third party trust planning.

polled attendees at the Barrett/Phelps SNT presentation had, in the past year, drafted a strict SNT, either as the primary trust or an alternative receptacle trust. The strict SSI SNT should still pass muster in Ohio. Ohio Rev Code §1339.51(D)(4) [2000]

6. Discretionary, explicit authority to reduce benefits (“on/off,” or “spigot”):

Practitioners developed the on/off spigot trust distribution standard because (1) the narrow strict SNT language described above frustrated clients, and (2) trustees needed to understand that in some situations reducing a public program benefit was defensible, if the beneficiary was overall better served by the particular trust distribution. The on/off spigot SNT distribution standard is fully discretionary, but explicitly gives the trustee authority to reduce the public grant.

It is the intention of the Grantor to create a supplemental fund for the benefit of the Beneficiary.

The Trustee may make distributions of income and principal, as the trustee may determine, in his or her sole, absolute and unfettered discretion, to supplement any governmental or private programs for which the beneficiary may be eligible..

I ask the Trustee to make reasonable efforts to avoid making distributions that supplant services, benefits or medical care otherwise available to the Beneficiary from governmental or private sources, or both, unless the trustee has determined in his sole, absolute and unfettered discretion that the benefit to the Beneficiary from the particular trust distribution outweighs the reduction in a particular public benefit program that may be a consequence of the trust distribution.

Trustees need guidance about appropriate SNT distribution items, and the explicit authority to reduce the grant helped the trustee understand the implication of a distribution.

What are the sorts of public benefit items the trustee might buy privately? If the trust beneficiary lives outside an institution, trustees usually want to buy housing for the beneficiary. If the trust beneficiary is on SSI, then the trust’s payment of rent will reduce the monthly income grant in some amount, depending on complicated Social Security in-kind income rules. If a Medicaid eligible trust beneficiary cannot get an appointment to see a dentist for dental treatment, because no dentist in his or her community accepts the low Medicaid reimbursement rate, then the trustee may pay for a private dentist even though the Medicaid program ostensibly covers dental services.

The on/off spigot SNT distribution standard is most common in New York, where it is explicitly authorized by statute. New York’s EPTL 7.1.12(e)(2)(i)(5) provides that a supplemental needs trust may include an absolute discretion standard, and optional language permitting the trustee to “make distributions to meet the beneficiary’s need for food, clothing, shelter or health care even if such distributions may result in an impairment or diminution of the beneficiary’s receipt or eligibility for government benefits or assistance but only if the trustee determines that (i) the beneficiary’s needs will be better met if such distribution is made, and (ii) it is in the beneficiary’s best interests to suffer the consequent effect, if any, on the beneficiary’s eligibility for or receipt of government benefits or assistance.”

New York and New Jersey's spigot trust SNTs are mentioned in a Social Security Administration Program Operation Manual Section (POMS): "A SNT is a discretionary trust established to allow the supplemental needs of an individual with disabilities to be met with income of the trust. ... **The language of the trust will show that:3) the trustee is authorized to make distributions to third parties to meet the beneficiary's needs for food, clothing, shelter or health care, if the beneficiary's needs will be better met and it is in the beneficiary's best interests to suffer the consequential effect on his eligibility for government benefits ;.....**A SNT does not have special significance for SSA." POMS SI R01120.200 (A) (4).

At the NAELA 2001 Symposium in Vancouver, British Columbia, the polled attendees at the Barrett/Phelps SNT presentation indicated that some variant of the explicit authority to reduce benefits language was used in New Jersey, New York, Connecticut, Michigan, California, Washington, Alaska, Oregon, Wisconsin, Delaware, Pennsylvania, and Florida. The on/off trust would be a disqualifying resource in Ohio, as Ohio requires that a special needs trust contain no discretion to make distributions to supplant public benefits. Ohio Rev Code §1339.51(D)(4) [2000]

The distribution standard with on/off authority is preferred by sophisticated trustees, who want authority to reduce a particular public benefit if the trustee deems it useful. However, cautious practitioners in some states may still avoid using the on/off distribution standard unless protected by statute [as in New York EPTL 7.1.12(e)(2)(i)(5)].

E. Conclusion

Knowing the distribution standard for the trust under review begins the process of answering the question "Will this trust work?," but does not end the analysis.

Elder law attorneys need further research on

- (a) SNT distribution standards, and
- (b) The impact of a particular SNT distribution on a particular public program administered in a particular jurisdiction.

Ruth Phelps, CELA, and the author presented an analytical approach to these topics at the 2001 NAELA Symposium, but the state-by-state and program-by-program analysis remains to be done.

Newly enacted state laws describe, and thus limit, special needs trusts in a particular jurisdiction. As a result, cross-state disability planning is becoming more difficult. The careful SNT drafter will allow for future modification of trust terms, including the distribution clause.