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Special Needs Trusts Update

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Means-tested public benefit programs such as Medicaid (which provides health insurance and payment for skilled care and other medical expenses), Supplemental Security Income (SSI), the Supplemental Nutritional Assistance Program (SNAP), Section 8 housing and similar welfare benefits, can provide critical funding for basic medical, dental, vision and skilled care, food, income and shelter for qualified elderly or disabled individuals, but such programs generally provide only the basics and have strict financial limits.

Qualifying for Medicaid requires low income and assets. In New Jersey, a single individual must have less than $2,000 in all of his financial accounts combined (including all bank, brokerage, certificate of deposit, 401(k), individual retirement accounts, United States savings bonds, and the cash surrender value of any whole life insurance policy he may own).

But how can impoverished, disabled individuals afford to live in the community? The low income and asset requirements leave little funds available for comfort and enrichment activities, Uber or Lyfts to the doctor's office, expensive medications outside the Medicaid formulary, additional hours of care beyond that approved by the Medicaid Managed Care Organization (MCO), non-routine dental or vision care, and so forth. Using a special needs trust can solve these problems.

A special needs trust can be a very effective strategy to enhance the lifestyle of a disabled individual, while preserving the individual's eligibility for means-tested public benefits. Additional health services and medical equipment, specialized therapies, and private health insurance premiums, education and vocational training and job coaching, household goods, furniture and appliances can be paid from a special needs trust, as can cable television, home appliances, and computers and software. Payment for the cost of a specially equipped automobile can be an allowable expense, provided there is only one vehicle in the household of the disabled individual. The costs of personal services, including care management services and language translation services provided to beneficiaries whose primary language is not English, can also be allowable expenses. See e.g. Wong v. Dainies, 582 F.Supp. 23 475 (S.D.N.Y. 2008) (use of a special needs trust to pay for a Cantonese-speaking aide). Special needs trusts can also be used to pay for the costs of recreational activities, including domestic travel expenses for the beneficiary and certain companions.

The use of special needs trusts is encouraged as a matter of federal and state public policy. Special needs trusts receive special treatment under federal law and under New Jersey law. The funds held in a special needs trust can be used to assist the disabled trust beneficiary without disqualifying that beneficiary for means-tested public benefits, even though the funds in the trust are in excess of the countable resource limits for the various public benefits programs. As stated above, a disabled, single individual residing in New Jersey could not qualify for Medicaid if he owns more than $2,000 in countable assets in his name. However, if the same disabled individual was the beneficiary of a properly established and funded first party self-settled special needs trust, potentially hundreds of thousands of dollars could be held in the special needs trust and used for the benefit of that disabled individual, without disqualification from Medicaid.

Similarly, under newly adopted regulations which took effect on October 18, 2018, if a United States military veteran seeking to qualify for the Veteran's Administration Improved Pension (a financial benefit which qualified veteran's may use help pay for the cost of their care in the home or in a long-term care setting), the individual may transfer their assets to a special needs trust for another disabled individual without incurring a penalty period disqualifying the veteran from the Improved Pension.

There are two basic categories of special needs trusts, and those categories are based on who provided the funds deposited in the trust. First party special needs trusts are established pursuant to the federal Medicaid statute, at 42 U.S.C. 1396p(d)(4)(A) and (C), and are sometimes referred to as "self-settled" or "payback trusts." See e.g. Wong v. Dainies, 582 F. Supp. 23 475 (S.D.N.Y. 2008). These trusts must be established using only the assets of the disabled individual, for the sole benefit of a disabled beneficiary. Trusts established under (d)(4)(A) may be referred to as self-settled special needs trusts. Trusts established under (d)(4)(C) are referred to as pooled trusts. Both (d)(4)(A) trusts and (d)(4)(C) trusts are funded with first party assets. By contrast, third party common law special needs trusts (sometimes referred to as "supplemental benefit trusts") are funded with third party assets, i.e., with money belonging to someone other than the disabled beneficiary.

For instance, a (d)(4)(A) or a (d)(4)(C) first party special needs trust could be set up by an individual, under the age of 65, who was severely injured as the result of medical malpractice, and becomes involved in a medical malpractice lawsuit. Instead of receiving the accident settlement proceeds outright (which would disqualify the disabled individual for Medicaid until the settlement proceeds were spent down to below the $2,000 threshold), the individual could agree that the lawsuit settlement will be paid into a first-party special needs trust by the medical provider's insurance company. This would potentially protect the entire net settlement proceeds, preserving a fund to pay for special needs, while keeping the disabled beneficiary on Medicaid, Supplemental Security Income (SSI) and other means-tested federal welfare benefits.

It used to be that a first party special needs trust could only be created by a parent, grandparent, or guardian of a disabled person, or by court order. This restriction changed as the result of the Special Needs Trust Fairness Act of 2016, which took effect on December 13, 2016. As of that date, a first party special needs trust can now be established by a mentally competent, disabled individual. If the disabled individual is not mentally competent, the first party special needs trust can be set up by the parent, grandparent, or guardian of the disabled individual or by a court order authorizing the establishment and funding of the trust.

As a general rule, any use of a first party special needs trust funds must be limited to pay for the special needs of the disabled beneficiary, which are the items, products or services provided to the beneficiary to assist in the care, management, or treatment of the beneficiary's disability and to improve the quality of his beneficiary. Under the "sole benefit rule," which applies to first party special needs trusts and first party pooled trusts, the income and assets of a first party special needs trust can provide no more than an incidental benefit to anyone other than the disabled beneficiary. See Social Security Program Operations Manual System (POMS) SI 01120.201F (effective date of April 30, 2018).

Fortunately, when properly drafted, funded and administered, a special needs trust can also provide spend thrift protection. Under New Jersey law, trusts with valid spendthrift provisions cannot be terminated early by the consent of the beneficiaries and are not subject to attachment by their creditors. See e.g., In re Estate of Bonardi, 376 N.J. Super. 508 (App. Div. 2005); Restatement (Second) of Trusts, §337 (1959), at comments 1, m and n. The purpose of a spendthrift provision is to prevent a trust beneficiary's creditors from attaching or otherwise controlling either the principal distributions or the income stream to the beneficiary from the trust.

Certain strict requirements must be met in order for a special needs trust to be effective. In addition to complying with the sole benefit rule and the age requirement, both types of first party trusts, (both (d)(4)(A) and (d)(4)(C) trusts), must also contain very specific payback language. This language must name the state or states paying the Medicaid benefits as the first payee of the funds remaining in the trust at the time of the death of the disabled beneficiary up to the value of the total Medicaid paid on behalf of that beneficiary under the Medicaid plan of the state or states in question. POMS SI 01120.203 B.1.h. There are limited exceptions to this rule for certain allowable administrative expenses, such as state and federal taxes due on account of the death of the beneficiary and reasonable administrative fees associated with the trust or its termination. POMS SI 01120.203.B.2.g.3.a. However, funeral expenses, debts owed to third parties and inheritance taxes due for residuary beneficiaries cannot be paid prior to any reimbursement to the state for governmental benefits paid. POMS SI 01120.203.B.2.G.3.b. This restriction

makes first-party special needs trusts unsuitable for the transfer of wealth to a private, non-disabled beneficiary, upon the death of the disabled beneficiary.

The second type of first party, self-settled special needs trust is a (d)(4)(C) trust, or the pooled trust. This is a "master trust" run by a non-profit entity with separate individual accounts established solely for the benefit of each disabled beneficiary. POMS SI 01120.203.B.2.a. Being relatively inexpensive to establish and administer, a pooled trust is often the obvious choice when cost considerations predominate.

Unlike (d)(4)(A) special needs trusts, there is currently no age restriction on (d)(4)(C) pooled trusts in the Third Circuit Court of Appeals. The state Medicaid agencies located within the jurisdiction of the Third Circuit Court of Appeals may not impose a Medicaid penalty period for the transfer of funds into a pooled trust by a disabled beneficiary who is over the age of 65. Lewis v. Alexander, 685 F.3d 325 (3d. Cir. 2012).

A Medicaid penalty period is a period of time during which the person will have no institutional care paid for by Medicaid, because the person made an uncompensated transfer, or gift, for less than fair market value, during the five year period immediately preceding the filing of the first application for Medicaid on behalf of that individual. Since the individual is already financially eligible for Medicaid, and thus impoverished, the Medicaid penalty period presents a problem, because without careful planning, the individual is left with no money to pay for care, and cannot finance the care through Medicaid until the penalty has been served. The length of the penalty is computed based on the value of the gift.

The Lewis decision allows an individual over the age of 65 to fund a pooled trust for himself without a penalty period. This case law applies to Medicaid agencies located in New Jersey, Pennsylvania, Delaware and the United States Virgin Islands. As a result of the Lewis decision, Medicaid agencies in these locations cannot impose a penalty period for a transfer by an individual over age 65 to a pooled trust, without legal recourse by the disabled pooled trust beneficiary to remove the penalty period. However, this is not always the case beyond the borders of New Jersey, Pennsylvania, Delaware, and the Virgin Islands.

Outside the Third Circuit Court of Appeals, the question of whether a Medicaid penalty may be imposed on an individual over the age of 65 who funds a pooled trust is the subject of controversy. In some states, such transfers are not penalized. In other states, Medicaid penalties are imposed. The question may eventually be submitted to the United States Supreme Court or taken up by Congress.

In addition to first party special needs trusts ((d)(4)(A) trusts), pooled trusts (or (d)(4)(C) trusts), there is another broad category of special needs trusts, i.e., third party trusts, which are funded exclusively with the assets of someone other than the disabled beneficiary. These trusts are known as third party common law trusts and may also be referred to as supplemental benefit trusts. They can be established during the third party's lifetime, or established as a result of their death. For instance, a parent of a disabled child could establish a testamentary third party trust in his will, and that trust would take effect after the death of the parent.

When third party supplemental benefit trusts are correctly drafted, funded and administered, these trusts are disregarded as countable assets for the disabled beneficiary and will not disqualify the disabled beneficiary for Medicaid and other means-tested public benefits programs. It is very important, however, that the disabled beneficiary never add any of his own assets to a third party supplemental benefit trust. POMS SI 01120.201 A 2. If that happens, then that portion of the trust may be regarded as a countable asset to the disabled individual, potentially resulting in disqualification for Medicaid and other federal benefits.

In conclusion, using a properly drafted and properly administered special needs or supplemental benefit trust can be an invaluable tool to preserve a disabled individual's eligibility for public benefits while setting aside a fund to enhance the quality of life of the disabled beneficiary.

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