Special Needs Trusts

By Mark W. Dellinger
Rhodes, Butler & Dellinger, PC

Special needs trusts (sometimes called "supplemental needs" trusts) allow a disabled beneficiary to receive an inheritance, gifts, lawsuit settlements or other funds without losing eligibility for certain government benefit programs, such as Supplemental Security Income (SSI) and Medicaid. We draft these trusts so that the funds are not treated as the asset (or "resource") of the beneficiary. This means that the assets do not cause the beneficiary to lose eligibility for public benefits, yet there is an extra pool of funds to help the beneficiary. Special needs trusts are not support trusts. This means they are not designed to provide basic medical or health support. Rather, special needs trusts are intended to pay for items (many are considered staples of life but also comforts and luxuries) that are not paid for by public assistance funds. These trusts typically pay for things like a microwave, a trip to the movies, cable television, a camera, deodorant, detergent, education, recreation, counseling, health and beauty products, and other things beyond the simple necessities of life.

Types of Special Needs Trusts

In the most general sense, we draft two types of special needs trusts: third-party and first-party. Third-party special needs trusts fall into two categories: one for disabled family member, such as a child, and one for a spouse who is having long term care paid for by Medicaid. The first type is created by a parent or other family member for a disabled child or relative (even though the child or relative may be an adult by the time the trust is created or funded). The second type, a testamentary (part of a will) special needs trust for a spouse who is on Medicaid, can preserve wealth for other family members.

Advantages of a Third-Party Special Needs Trust

A standalone (not part of a will) third-party special needs trust is a much better solution than cutting the disabled child out of the will. Many parents do just that: they leave their estate to their children who do not have disabilities, thereby excluding the disabled child because he or she is unable to manage the funds. This is a bad idea for several reasons:

First, what happens to those funds if the child who is inheriting his or her disabled sibling's share has creditors or goes through a divorce? Those funds will be counted as the non-disabled child's funds.

Second, what happens to those funds if the child who is inheriting his or her disabled sibling's share dies? Where do those funds go then?

Third, it may not be clear if how much of the inherited money is to be used for the disabled child versus how much can be used by the child who is not disabled. Leaving the disabled child's share to more than one child who is not disabled can be a disaster. For instance, if one sibling sets money aside for the disabled sibling, and another child does not, resentments can build that may split the family.

Fourth, relying on one's other children to take care of their siblings places an undue burden on them and can strain relations between them.

Fifth, public benefits programs and individual circumstances change over time; what is appropriate now may not be appropriate in the future. Public benefits programs often do not provide adequate care so the needs of the disabled person may need to be supplemented.

Estate Planning and the Special Needs Trust

In order for a plan involving a special needs trust to work, the parents' estate plan must be modified. Any inheritance for the disabled child should be left to the special needs trust. Parents should tell family members who might wish to gift or leave assets to the disabled child that they must direct all gifts and bequests for the child to the trust. Beneficiary designations on all life insurance policies, IRAs, retirement accounts, etc., must be changed so that the proceeds are directed to the special needs trust; otherwise they will pass to the disabled child.

It is important that third-party special needs trusts be drafted as qualified disability trusts to take advantage of income tax laws.

First-party special needs trusts (sometimes called "self-settled" or "self-funded" trusts) are frequently established by individuals who become disabled as the result of an accident or medical malpractice and later receive the proceeds of a personal injury award or settlement. The disabled individual, if able, or his or her guardian or parent, if unable, may create such a trust. Each public benefits program has restrictions that the special needs trust must comply with in order not to jeopardize the beneficiary's continued eligibility for public benefits. This type of special needs trust is complex. Special consideration needs to be given to whether or not to make this type of trust a grantor trust for income tax purposes.

Special note: The trustee of a special needs trust beneficiary who is receiving SSI has to be very careful to not make expenditures for food and shelter (clothing restrictions no longer apply) unless the trustee carefully concludes that doing so is in the beneficiary's best interest despite a possible loss of or reduction in public assistance benefits.