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Supplemental or Special Needs Planning

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I. Introduction

Parenting a child or dependent with special needs takes special planning. Particular needs will always be present and you must consider and prepare for them. Taking steps now can help arrange for your loved ones well being, today and tomorrow. Areas you should consider include, among others, balancing work and family, obtaining the proper medical treatment and appropriate special education services, planning for the future for a child with special needs, integrating government benefits into the process and selecting a guardian and/or trustee. Interestingly, obtaining information on medical treatment is often much easier for families than obtaining information on special needs. In a recent survey, 55% of respondents felt that information on financial assistance is extremely difficult or difficult to obtain compared to only 34% of respondents who felt that information on medical treatment is extremely difficult or difficult to obtain.^{1a} This issue of *Legal & Tax Trends* will address this critical need for information by discussing the various options available, with particular focus on integrating government benefits and special needs trusts.

The laws governing special needs trusts and other areas discussed in this article will differ by state. In addition, these laws are subject to legislative change, as well as judicial and administrative interpretation.

Therefore, it is imperative that one not rely on the materials in this article without first consulting with a professional who specializes in this area.

More than 54 million Americans report some level of disability. For 35 million of them, the disability is severe.¹ The major concern of parents is what will happen to their child when they die or become unable to care for him/her because of their own aging. Unlike caring for a well child, special needs support generally involves providing a lifetime of care, which can be daunting for a family to even consider. In developing a flexible estate plan for a family who has a child with special needs, certain issues need to be addressed:

- The availability of government benefits and the possible imposition of cost of care liability;
- Knowledge of both the needs of the child and the family's resources;
- Selection of guardian and trustee;
- Planning options; and
- Types of special needs trusts.

II. Government Benefits and Cost of Care Liability

There are certain federal and state benefits generally available to individuals with special needs providing they meet certain criteria. Social Security benefits are generally available if the child is disabled prior to the age of 22, and one parent is covered by Social Security and subsequently dies, retires or becomes disabled. Benefits are also available through the federal Supplemental Security Income Program (SSI). Under SSI, which is a means based program, the child will receive monthly checks and may be eligible to receive medical benefits, training, housing and social services. If the child is "financially needy," Medicaid assistance is also available. The federal government and each individual state fund Medicaid jointly. An individual with special needs may also be eligible for Medicare, free legal assistance, federal food stamps, certain veterans and dependent's benefits and certain housing benefits. Eligibility for many of these benefits can be lost if the individual has too much income or too many assets. Generally, if an otherwise eligible individual receives more than \$2,000 in assets, government benefits may be lost.² If a special needs child is under age 18, unmarried, and lives at home with parent(s) who do not receive SSI benefits, a

¹ U.S Census Bureau, American with Disabilities, Household Economic Studies, 2005 (Issued December 2008)

² 42 U.S.C. §1382(a)(1)(B); 20 CFR §416.1205(a), (c).

portion of the parents' income and resources are considered to be available to the child when determining whether the child qualifies for benefits. Since the cost of care can be extremely high, a cost of claim liability against a child with special needs can quickly erode the child's assets or the assets held in any trust established for the child's support.

III. Knowledge of the Child's Needs and Family Resources

The first step in this process involves understanding the child's short- and long-term needs. The diagnosis is not nearly as important as the prognosis or actual current skill level. The term "special needs" often holds different meaning for each person, depending on the age of the individual and his or her individual impairments. For someone of school age, it may mean that the child is receiving school-based services under IDEA, the Individuals with Disabilities Education Act, such as occupational and/or physical therapy or it may mean that the child is placed in resource type classes. As an adult, it typically means an inability to work and perform one of the skills of daily living such as bathing, toileting, dressing, feeding, etc.

Parents must explore the realistic possibilities for living independently and the child's potential for self-support (or partial self-support) and for managing his or her own financial affairs. Without this information, it will be difficult to properly project the future financial needs of the child. The development of an appropriate estate plan for a family who has a child with special needs also depends upon a full and complete understanding of the parent's financial situation, assets, liabilities and objectives. The size of the estate and the amount of assets that the parents wish to devote to the care or support of the child with special needs must be determined. The role of governmental benefits in supporting the child and the cost and availability of private or public institutions or alternative arrangements for care must also be understood. This information will help the parent make sound and realistic choices for the child's future within the context of the entire family's needs and resources. Lastly, the family must review the arrangements they have made on a regular basis as the child's needs, the laws regarding benefit eligibility, and the resources available to the child are continually changing.

The Health Insurance Portability and Accountability Act (HIPAA) has seriously impacted families with a child with special needs. HIPAA was designed to protect the privacy of medical patients and the integrity of their medical records. Under HIPAA, doctors and other healthcare professionals are not permitted to talk freely about a patient's medical condition.

While privacy is a well-intentioned objective, it can have unintended implications for the medical care of individuals with special needs. Parents should plan ahead on how they can best participate in medical decisions for their adult child

with special needs. If the parent believes that his or her child with special needs may lack the capacity to understand and make responsible medical decisions, there are steps that they can take to ensure legal access to medical and mental health information for the child.

Parents have at least three options:

First, when the child reaches 18, the parents can petition a court to declare their child mentally incompetent and thereby become the child's legal guardians. In some instances, parents may seek a limited guardianship for medical care, which grants them the legal right to make medical decisions. Parents may choose to obtain full guardianship when a severe developmental or physical disability prevents their child from performing even the most basic functions.

Second, the parents could be designated the attorneys-in-fact under their child's health care proxy. A power of attorney authorizes a person (i.e., the agent) to act on behalf of the principal (i.e., the person who signed the power of attorney). The authority granted may be general or it may be restricted to specific activities. The document should contain HIPAA release information and name the agent as a personal representative under the HIPAA rules so the agent can legally request and receive confidential medical information. By being designated the agent under a health care proxy, the parent can make certain medical decisions on behalf of the child. Parents who choose this option may need to hire an independent expert to evaluate and certify that the child has the requisite legal capacity to execute the document.

Finally, the parents could obtain a signed release or consent form from the child. This assumes that the child has the capacity to make an informed consent. Obtaining a release or consent form from the child is the least intrusive way for a parent to gain access to vital medical information without infringing on their child's independence. It is important to know that a release or consent form is generally only valid for a limited period of time and only for a particular physician or medical institution. Because each family's circumstances are different, each family must choose the option that best meets its needs. It is also worthy of note that the three options discussed may function differently from state to state, so parents should discuss their situation with an attorney experienced in special needs planning before making this important decision.

IV. Selection of Guardian

The selection of a guardian and trustee can be one of the most complicated issues for parents of a child with special needs. Choosing a person who can provide care and maintenance for a child who may never become independent can be a daunting experience. If the child is a minor, the parents are the natural guardians of the child until the child reaches the age of majority. After reaching

the age of majority, the child may be considered legally competent unless declared incompetent by a formal adjudication. Parents are often unaware that they have no legal authority to act for the child once he/she reaches majority.

Whether a child with special needs, upon reaching the age of majority, should be declared incompetent is often debated. While guardianship proceedings have been simplified in many jurisdictions, it can still be time-consuming and expensive, as guardianship requires the posting of bond and court supervision and approval. In addition, the formal process of adjudging the child incompetent may carry a stigma and lead to an infringement upon the civil rights of the child. Lastly, property subject to guardianship is deemed to be property of the ward and will be subject to cost of care liability.

In an effort to address the above concerns, many states have enacted statutes that provide for limited guardianship or permit a court to authorize a guardian to perform selected transactions relating to a specific property, or certain types of service or care arrangements. Other states permit a competent individual to designate a person to act as guardian if he/she later becomes incapable of managing his/her own affairs. Generally, the court will honor the parent's designation if it is in the child's best interest.

Some parents opt for a less formal arrangement than a guardianship, such as a family member or friend who would be willing to provide the necessary support to the child with special needs after the parent's death. Unfortunately, this approach may jeopardize government benefits as some states have aggressively treated assets held by other family members for the benefit of the child with special needs as countable assets. Furthermore, even if this arrangement works initially, the problem is that circumstances may change. The person who the parents counted on to handle the responsibilities may not be willing or able to serve. Lastly, if a family member or friend is not legally obligated to support a child with special needs, payments made on that child's behalf might be taxable gifts.

Parents may also elect to avoid a formal guardianship during their lifetime and nominate a guardian by will. This avoids the incompetency determination but may still require an adjudication of incompetency at the surviving parent's death. Parents should also be informed that the nomination of a guardian is not equivalent to an appointment and that only the probate court can appoint a guardian. In the event of a controversy, the court will be bound by a "best interest" standard, which could lead to an appointment different from the parents' nomination.

Great care should be taken in finding the best person to look after the personal care of the child with special needs. The age of the nominee should be taken into consideration since the appointment may be life-long. Also, a guardian close in age to the child may be more sensitive to the age-appropriate needs and interests of the child. It is also helpful if the guardian knows the child well. The

person nominated should understand the mental, physical, emotional and medical condition of the child with special needs, since it is this person who will advocate for the child after the parents' death. It is the guardian who will ensure that the adult child is receiving adequate services and medical care, who will determine if a move from one group home to another is in the best interests of the child, and who will intervene if the child is being physically or verbally abused. Geographic proximity is also a concern in selecting a guardian. Often a sibling or other relative is capable and truly willing to serve. Their interest in this role, however, should never be assumed. If there is no one willing or able to serve, the parents may obtain help through local non-profit organizations or specialized agencies.

The person to be nominated in the will should be contacted to determine his/her willingness and ability to serve. Several persons should be named in succession in the will as possible guardians so that if the first person named as guardian is unwilling or unable to serve, the next person nominated can be considered for appointment as guardian for the child. Given the importance of the guardianship issue, parents of a child with special needs should review their guardianship nomination periodically.

If an adult special needs child is mentally competent, he or she could appoint an attorney-in-fact via a general durable power of attorney. A general durable power of attorney will permit the person named as the power of attorney to assist the special needs child in his or her financial affairs. A durable power of attorney can be conditioned upon one's inability to take care of his or her financial transactions but more often is not so limited and being durable, remains effective upon incapacity. Depending on the circumstances, this may be an alternative to a guardianship.

V. Selection of Trustee

If the decision is made to use a trust, the trustee will have the responsibility of managing the trust assets and distributing the trust property to the beneficiary (ies). The selection of a trustee will require a choice between a trustee who is related to the grantor and one who is a trustee by profession (bank, trust company, private trustee, accountant or lawyer). There are advantages to using a family member trustee. A family member is likely to be familiar with the special needs of the child and all of the grantor's wishes. In addition, a family member might serve without charging a fee. Lastly, the grantor may have more confidence in the ability of the family member to carry out the terms of the trust than a large, impersonal institutional trustee.

A family member trustee could also pose some significant disadvantages. A family member trustee may not have the background (or the time) to manage the investment, tax planning, accounting and other administrative responsibilities

required. A family member trustee who is also a contingent beneficiary may have a conflict of interest, or be placed in a difficult situation when discretionary distributions must be made. Furthermore, with a family member trustee, there is often no deep pocket from which to recover damages in the event of negligence. Another disadvantage is that a family member trustee may die, become disabled or move to another part of the country. A corporate trustee offers more permanence, even though it may merge with another corporation.

Another option is to name a family trustee and a professional trustee to serve as co-trustees. The advantage of this approach is that the family trustee can provide valuable input with respect to the needs and challenges of the child, while the professional trustee can provide the requisite expertise and objectivity. There is, however, unlikely to be any fee savings since most professional trustees will still charge their customary fees.

The trustee of a special needs trust should be familiar with SSI regulations, Medicaid law and other public benefit laws.

VI. Estate Planning Options

There are a number of estate planning options:

Disinherit the Child

This option to omit the child with special needs from the parents' estate plan is no longer seen as viable as the child becomes a ward of the state, negatively impacting the child's quality of life. While this is sometimes done in situations where the assets are not adequate to meet the family needs, most parents do not want to omit a child from their estate. Many parents feel that a well child has the ability to provide for himself while a child with special needs does not. Parents most often want additional resources to be made available to improve the child's quality of life, not less.

Outright Bequest to Child

In some cases, a parent may leave his or her property outright to the child with special needs. This generally happens when the parents have not taken the steps to put a proper estate plan in place. There are several disadvantages of an outright gift: (i) the child may not be able to handle the finances; (ii) the receipt of those funds will render the child ineligible for Medicaid and other benefits until the funds are exhausted; and (iii) property held in the child's name is available to his or her creditors.

Outright Gift to Other Family Members for Benefit of Child

Clients may be intimidated by the complexity of a trust or think it unnecessary. Sometimes a parent will leave property to another sibling (or close relative) on the informal understanding that the sibling will take care of the child with special needs. While this is relatively simple and inexpensive, there are many disadvantages. First, some states have aggressively treated assets held by other family members for the benefit of the child with special needs as countable, jeopardizing government benefits. Second, the other sibling will have gift, income and estate tax consequences by holding the money. Third, the funds are subject to the other sibling's creditors and may be lost in the event of divorce, bankruptcy or litigation. Fourth, the other sibling may die, and the funds may unintentionally pass to others. Fifth, the other child has no legal obligation to use the funds for his/her sibling with special needs. There is no guarantee that over an extended period of time they will be available for the child with special needs. Finally, if the other sibling has children and are applying for student financial aid, the receipt of those funds may jeopardize the children's financial aid eligibility.

- ***Proper Estate Planning***

Careful attention must be paid to the estates of parents who have children or dependents with special needs. Lack of planning and even the use of common will/trust provisions can limit the person's qualification for state and federal entitlement programs. Proper estate planning for a family who has a child with special needs will often include the following:

Review of Beneficiary Designations

Parents should review all assets in which beneficiary designations are required, such as life insurance, annuities, individual retirement accounts and pension benefits. The child with special needs should not be designated as either the primary or contingent beneficiary.

The Letter of Intent

It is helpful to have the parents prepare a letter of intent or a memorandum of suggestions or instructions to the person(s) who will care for the child with special needs. While not legally binding, it can reflect the parents' thinking on a range of issues and provide a blueprint for the caregiver to follow in understanding the child and the parents' wishes. The letter can address such issues as the parents' hopes and aspirations for the child and their preferences for the child's living arrangements and service providers. The memorandum can detail the child's medical history, daily care needs, emergency contact information, the child's likes, dislikes and interests, religious practices, etc. The

letter is a working document that can be easily changed without having to comply with the formalities of amending a will.

Making a Will

For families with a child with special needs, it is critical that both parents have a will. If a parent dies without a will, probate assets will pass under the applicable state laws of descent and distribution. In most states, a portion of the property would pass to a surviving spouse and a portion would pass outright to the children. As noted above, if a child with special needs inherits more than \$2,000, most government benefits may be lost. In addition to protecting family assets, a will also enables a parent to select a guardian for his or her child with special needs. To ensure that the parent's wishes are implemented, wills by both parents must be executed naming the individual as fiduciary.

Setting up a Special Needs Trust

In many instances, the drafting of a trust for the benefit of the child with special needs is the most appropriate mechanism to provide for the needs of the child. In the most common estate plan for a child with special needs, no assets would be placed in the third party special needs trust while the parents are alive. At the death of the surviving parent, the will would transfer the child's share to the third party special needs trust established for his/her benefit instead of transferring the share of property outright to the child with special needs. The parents could also designate this trust as beneficiary of life insurance policies, pension benefits, IRAs and other assets that pass by contract.³ Parents should also inform friends and relatives that a special needs trust has been established for their child's benefit and that any funds which they may have been earmarked for that child's benefit should pass directly to the trustee of the special needs trust. Creating the special needs trust as a stand alone document (instead of as part of a will) ensures the terms of the trust and the assets in it are entirely private and not a matter of public record.

The trust can be flexible so as to take into account the changing needs and abilities of the child with special needs. The trust can be designed so that the trust property is protected from the creditors of the child and should include the strongest possible spendthrift provision. By giving the trustee authority to make discretionary distributions for the benefit of the person with special needs, the trust can be designed so as not to lose government benefit eligibility. The trust

³ IRAs, 401(k)s and 403(b)s, among others, can be an inefficient method of funding a special needs trust ("SNT"). Nevertheless, if retirement benefits must be paid to the SNT, the trust should not include a conduit trust payment provision, as the required minimum annual distribution that would flow outright to the child with special needs would negatively affect his or her means-tested public benefits. Source - "Top 15 Tips for Estate Planners When Planning for Special Needs", by Katherine N. Barr, Richard E Davis and Kristen M. Lewis, *Probate & Property*, March/April 2010. Be sure to consult with an attorney experienced in special needs planning regarding other considerations.

instrument should clearly state the grantor's intent that the trust property be used to supplement governmental benefits and not supplant them.

To further protect the assets in the event of future changes in Medicaid law, the trust could permit distributions to other beneficiaries (e.g., siblings). At the child's death, the terms of the trust can control the ultimate disposition of the trust property. The trust property can pass to the child's siblings or to others that the parents designate. Lastly, if the family has more than one child with special needs, it will be necessary to establish a separate special needs trust for each child.

Often parents prefer to shift a larger portion of their assets to the special needs trust for the disabled child. Depending on the ages of the other children, and assuming the special needs child does not have a first party special needs trust, common apportionment percentages for a family with one child with special needs and two "typical" children include 50/25/25 and 40/30/30.⁴

VII. Special Needs Trusts

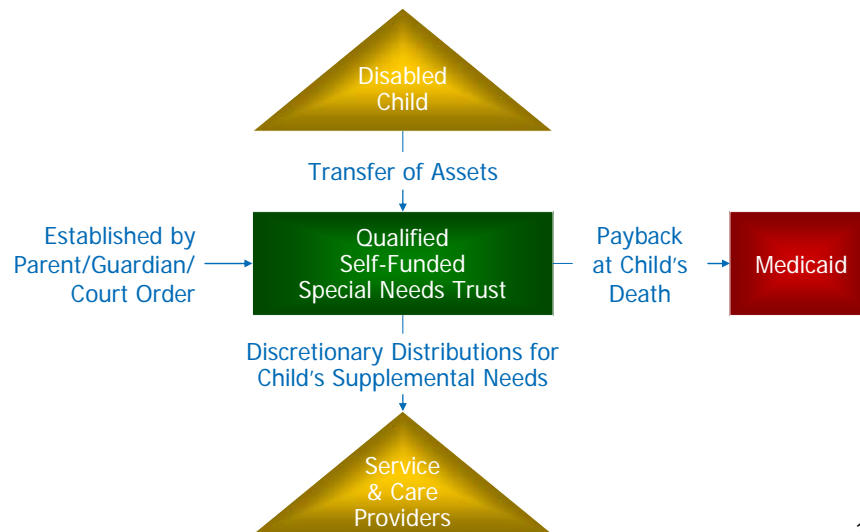
There are two sources for funding a special needs trust: assets belonging to the trust beneficiary (the child with special needs; e.g., first party) and assets contributed by a third party (e.g., the parents). This distinction is critical and can result in dramatically different treatment of trust assets, especially at the death of the trust beneficiary. While there are many types of special needs trusts, we will focus on only four of the most common types. There are two types of trusts that are established with the beneficiary's own assets: the Qualified Self-Funded Special Needs Trust or (d)(4)(A) Trust and the Qualified Pooled Special Needs Trust or (d)(4)(C) Trust. In addition, there are two general types of trusts that are established with a third party's assets: the Third Party Special Needs Trust and the Qualified Third Party Special Needs Trust.

⁴ "Top 15 Tips for Estate Planners When Planning for Special Needs", by Katherine N. Barr, Richard E. Davis and Kristen M. Lewis, *Probate & Property*, March/April 2010.

A. Qualified Self-Funded Special Needs Trust or (d)(4)(A) Trust⁵

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Qualified Self-Funded Special Needs or (d)(4)(A) Trust



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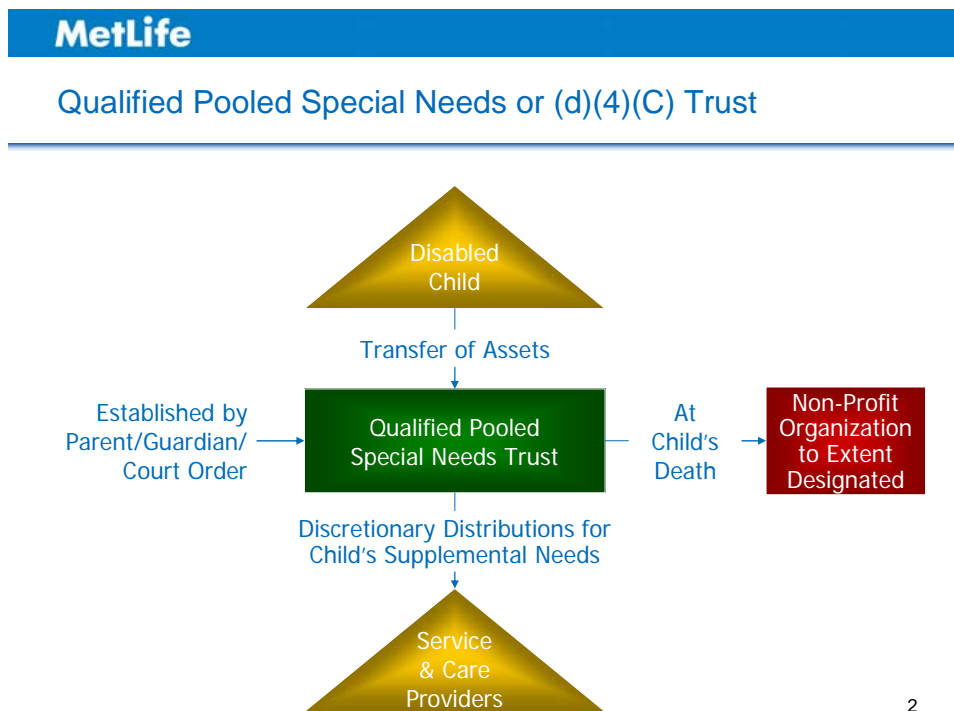
A Qualified Self-Funded Special Needs Trust is an irrevocable trust created for the sole benefit of an individual with special needs under age 65 and funded with the beneficiary's own assets. This trust must provide that Medicaid will be reimbursed for all of the benefits paid to the beneficiary upon the beneficiary's death. The Medicaid applicant/recipient cannot create the trust; it must be "established" by a parent, grandparent or guardian or by court order.

The most common use of the Qualified Self-Funded Special Needs Trust is to manage assets received by the Medicaid applicant/recipient from inheritance or lawsuit recovery. A transfer to this type of trust while the Medicaid applicant/recipient is under age 65 does not result in a period of ineligibility. The trustee can have discretion to distribute trust principal or income to the beneficiary and such discretion does not result in trust principal or income being countable. During the beneficiary's lifetime, the trustees can spend the trust property for the benefit of the person with special needs. Such in-kind distributions are also not countable. Thus, Medicaid can pay for home care or nursing home care, and the individual's supplemental needs trust can be used to pay for other quality of life goods and services. Distributions of trust property directly to the Medicaid applicant/recipient, however, are countable as income. Medicaid will pay for long-term care but must be repaid when the beneficiary dies. This is the "payback" provision.

⁵ 42 U.S.C. §1396p (d)(4)(A)

In order to limit the payback provision and to preserve as much of a judgment award as possible for the family, it is critical to create this type of special needs trust and have it approved by the court prior to constructive receipt of the monies. If the judgment award is first paid to the attorney's escrow account, it may be too late to limit the payback provision. The assets of a Qualified Self-Funded Special Needs Trust cannot be reached by Medicaid liens and can provide for the special needs of a beneficiary until the person dies or reaches the age of 65. The exception continues even after the individual reaches age 65. However, assets cannot be added to the trust after the individual reaches age 65.

B. Qualified Pooled Special Needs or (d)(4)(C) Trust⁶



The second type of self-settled trust is a Qualified Pooled Special Needs Trust. It is established with the Medicaid applicant/recipient's own assets and managed by a non-profit organization. The non-profit must maintain a separate account for each beneficiary of the trust, but for investment and management purposes, the trust pools these funds. The trust account is established by the parent, grandparent or legal guardian, by court order or the disabled individual. The most common use of the Qualified Pooled Special Needs Trust is to provide for the management of assets received by the Medicaid applicant/recipient from inheritance or lawsuit recovery.

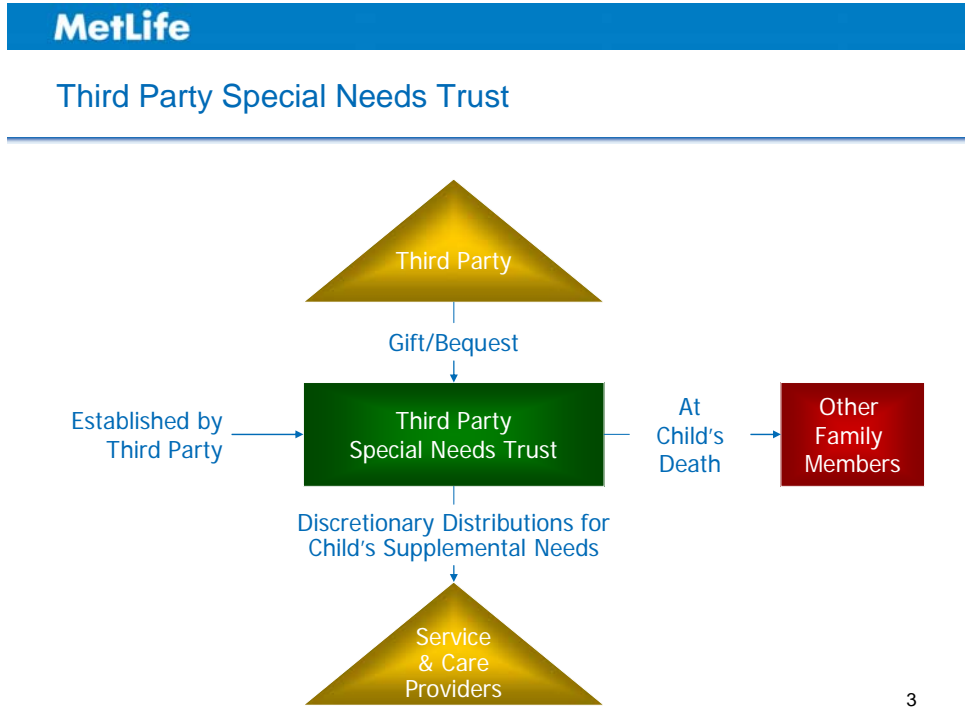
⁶ 42 U.S.C. §1396p (d)(4)(C).

There are two primary benefits from using a Qualified Pooled Special Needs Trust. First, the trust provides simplified paperwork. A Qualified Pooled Special Needs Trust is created by simply opening an account with the supplemental needs trust already established by the non-profit organization. Second, the family receives the benefit of working with an agency with expertise in this field. The non-profit organization has the skill to provide a lifetime of care and management to the individual with special needs. Thus, the Qualified Pooled Special Needs Trust may be appropriate for families who have a problem finding a suitable trustee when there are no relatives or friends to rely on, or for those parents who want the guidance of an agency with experience in this field. A serious concern with using a Qualified Pooled Special Needs Trust is that some pooled trusts have failed due to a lack of long-term resources.

A transfer to this type of trust does not result in a period of ineligibility with respect to a beneficiary under age 65. States differ as to whether a transfer to a trust results in a period of ineligibility with respect to a beneficiary age 65 or older. During the beneficiary's lifetime, the trustees can spend the trust property for the benefit of the person with special needs. Such in-kind distributions are not countable. Distributions of trust property directly to the Medicaid applicant/recipient, however, are countable as income.

After the death of the beneficiary, the non-profit organization will receive any funds remaining in the trust to the extent so designated. Medicaid will then be reimbursed for all benefits paid to the beneficiary. Finally, designated family members will receive distributions from any remaining money. To the extent that the non-profit organization permits a beneficiary's accounts to be paid to family members, the payback rules would apply to the amount to be distributed to family members. For instance, assume the beneficiary dies leaving \$100,000 in the trust, and the non-profit organization permits 50% of the remaining balance to be distributed to family members. In this situation, the \$50,000 to be distributed to the family will be subject to the Medicaid lien. Only after the lien has been satisfied will the family members receive the balance, if any.

C. Third Party Special Needs Trust



A Third Party Special Needs Trust is established for the benefit of a person with special needs but funded by someone else, usually a parent or other family member, to help meet the individual's needs to the extent not covered by Medicaid or other governmental entitlement programs. This trust is the most common type of special needs trust. The objective of the supplemental needs trust is to provide funds to supplement but not supplant the typical sources of support for individuals with special needs (i.e., SSI, Medicaid or other public benefits).

The primary use of a Third Party Special Needs Trust is to serve as a vehicle by which a parent provides supplemental support to a son or daughter, where family or professional trust management is desired and where the parent has other family members he or she wishes to provide for. The trust creates a whole management system to provide for both the anticipated and unforeseen supplemental needs of a person with special needs while not jeopardizing eligibility for basic support and care provided by governmental benefits.

The trustee of the Third Party Special Needs Trust will typically have the power to provide certain permissible or supplemental items to the beneficiary in the way that a parent might assist his/her child if the parent were still available and able to do so. For example, there are many items the government programs will not cover, such as trips to visit family members, reading material and personal

effects. The trustee will fill this gap and pay for these items without jeopardizing the government benefits.

Funding of this trust by bequest or by receipt of life insurance policy proceeds is not a disqualifying transfer. Trust property is not countable except to the extent that trust property is actually distributed to a Medicaid recipient/applicant. Trust property applied for the benefit of the Medicaid applicant/recipient is also not countable. The trust funds are not considered available to the beneficiary because the beneficiary does not have a legally enforceable right to receive the trust property. All monies distributed from the trust for the benefit of the Medicaid recipient/applicant are in the sole discretion of the trustee. In this way, the trust can provide benefits to an individual but not cause the otherwise eligible individual to be disqualified from government programs.

Trust property distributed to a person other than the Medicaid applicant under the terms of the trust is not a disqualifying transfer. Thus, distributions can be made to the primary beneficiary's siblings without disqualifying the Medicaid recipient/applicant. There is no need to have a payback provision to Medicaid in this type of trust. The trust assets can be used on behalf of the beneficiary with special needs, and then the remaining funds can be distributed—after the death of the person with special needs—to whoever was designated in the trust document. Since the law in this area is constantly changing and restrictions are being tightened by government agencies, trust documents must be flexible and be written to anticipate changes. The parties should consider giving a third party (e.g., a trust protector) the power to amend the special needs trust. This flexibility could prove invaluable in the event government programs or policies are changed.

- ***Funding the Third Party Special Needs Trust***

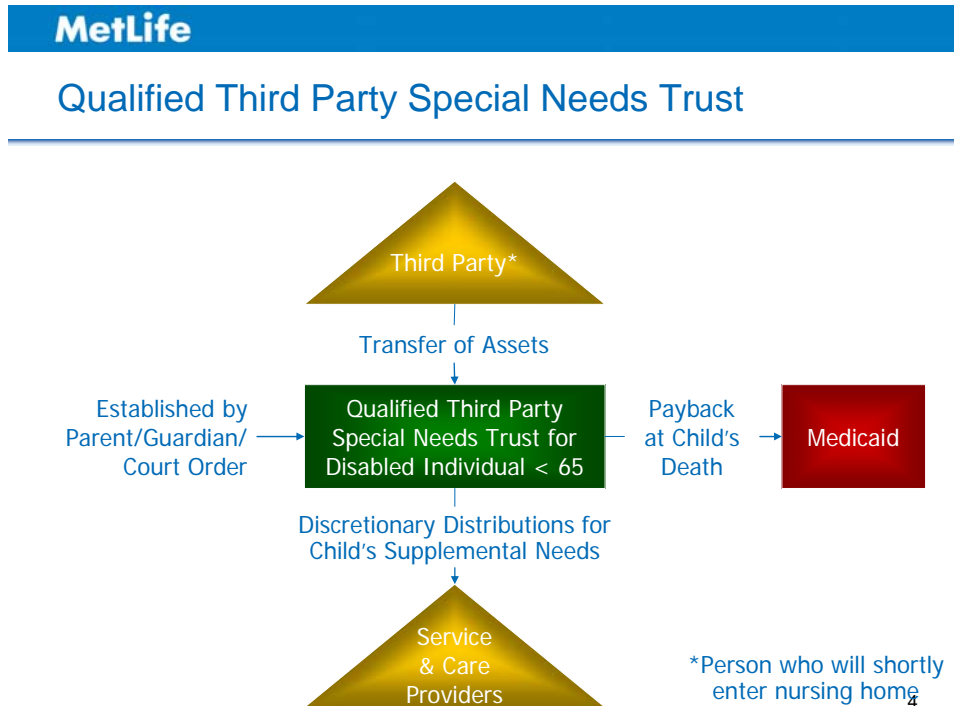
Once the third party special needs trust is established, plans must be made for its proper level of funding. It will be necessary to provide funds to cover the difference between what the government provides and the needs of child in order to raise the child's comfort level and improve his/her quality of life. Selecting the appropriate funding vehicle will be important. Real estate is one funding vehicle that may perform well over time. But, real estate is not liquid, may not provide adequate diversification and may not produce sufficient income. It also presents difficulties in management.

Other types of funding vehicles may not be appropriate to fund a special needs trust because of inherent tax disadvantages. For example, selecting the special needs trust to be the beneficiary of a qualified retirement plan or an IRA will, upon the death of the participant, result in the trust having to pay income tax earlier than expected. As another alternative, the special needs trust could be funded during life or at death with securities. The principal disadvantage with using securities, in addition to the inherent market risk, is that there may not be sufficient time to create a portfolio large enough to cover the projected need.

In many situations, life insurance on the life of the parent or on the joint and survivor lives of the parents may be the most attractive funding mechanism. The premium can be budgeted to fit within cash flow constraints. The death benefit

creates the right amount of money at just the right time to meet the expected need. The benefit is paid in cash so there are minimal management responsibilities. Furthermore, the death benefit is generally paid free of income tax and free of probate fees (and can be structured to be free of estate taxes as well), so it is cost efficient. Finally, life insurance leaves the existing estate intact and thereby preserves the other assets for other family members.

D. Qualified Third Party Special Needs Trust ⁷



A Qualified Third Party Special Needs Trust is an irrevocable trust created for the sole benefit of an individual under age 65 with special needs. It is created by a third party - the individual's parent, grandparent, guardian or a court - and funded with assets other than those of the individual with special needs. The trust must provide a payback provision, reimbursing the state for Medicaid services provided with any funds remaining in the trust at the individual's death.

The most common use of the Qualified Third Party Special Needs Trust is to facilitate the Medicaid eligibility of an individual with assets in excess of the eligibility limits who wishes to benefit a son, daughter, niece, nephew or other relative (or non-relative) with special needs. Recently passed legislation makes it more difficult for individuals anticipating a need for long-term care to transfer financial assets to relatives in order to hide them from Medicaid. These changes may result in increased attention paid to this type of special needs trust. While a parent, grandparent, guardian of the beneficiary or court must create such a trust, there is no requirement that the trust actually be funded

⁷ 42 U.S.C. §1396p (d)(4)(A) and 130 CMR 515.001 and 520.023 (D).

by an individual in any of these relationships. For example, the parent could establish this trust while the funding itself could come from a more distant relative or a family friend. Use of this trust allows the family unit to preserve more of its assets before qualifying for Medicaid. Assets in excess of the applicable Medicaid eligibility limits can be transferred to a Qualified Third Party Special Needs Trust to benefit a child, niece, nephew or other relative (or non-relative) with special needs.⁸

A transfer to this type of trust while the beneficiary is under age 65 does not result in a period of ineligibility. The trustee can have discretion to distribute trust principal or income to the child with special needs and such discretion does not result in trust principal or income being countable. During the beneficiary's lifetime, the trustees can spend the trust property for the benefit of the person with special needs. Such in-kind distributions are also not countable. Distributions of trust property directly to the Medicaid applicant/recipient, however, are countable as income. Medicaid will pay for long-term care but must be repaid when the beneficiary dies. This is the "payback" provision.

VII. Conclusion

Planning for families who have children or other dependents with special needs presents many challenges. An understanding of new areas, such as state and federal entitlement programs, special needs trusts and letters of intent, becomes critical. Without careful planning, assets bequeathed to benefit a person with special needs may instead be required to be used to pay for care or items that would otherwise be covered by government benefits.

⁸ Deficit Reduction Omnibus reconciliation Act of 2005

Legal & Tax Trends is provided to you by a coordinated effort among the advanced markets consultants. The following individuals from the Advanced Markets Organization contribute to this publication: Thomas Barrett, Michele Beauchine Collins, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei, Lillie Nkenchor and Barry Rabinovich. All comments or suggestions should be directed to Thomas Barrett at tbarret@metlife.com or John Donlon at jdonlon@metlife.com.

MetLife has a program, **The MetLife Center for Special Needs PlanningSM** which provides educational information and financial product solutions to assist parents with special needs children.

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