

I. Charitable Planning and Special Needs Trusts: *A Natural Combination*

By Katherine Barr

Parents of children with special needs extol the important role charitable organizations have played in their family's life. They likely could not put a price on the extraordinary value of the services these local agencies provide. Through estate planning documents, the family members of an individual with disabilities have a perfect and meaningful opportunity to show some of this appreciation to charities—while providing unique benefits to their family members.

A. Charitable and Special Needs Combinations.

When an individual seeks to provide benefits to charities, naming a charity as the recipient of a direct devise from a family member's estate is one simple way.

For the family whose goal is to maximize available funds for the child with special needs and who prefers that the distributions to charities be made only after the child's death, several options involving trusts exist. These options combine maximum use of public funds with the family's private resources for the child.

One option, combining charitable trusts with Special Needs Trusts, as discussed throughout this article, also allows an estate tax charitable deduction. The result is a win-win-win situation for the child with disabilities, the other family members, and the charities.

B. Protecting Public Benefits with Special Needs Trusts.

When Medicaid and SSI provide a portion of the child's medical and support needs, it may be critical for the long-term financial security of the child to make certain that those benefits are not interrupted or lost. To maximize government benefits available for a child with disabilities, parents can establish a Special Needs Trust to receive all of the child's inheritance. The trust can be included as part of their Wills or as a "stand-alone" document.

The Special Needs Trust is designed to co-exist peacefully with the child's eligibility for benefits. When carefully drafted and administered, the assets in the Special Needs Trust will not be considered an "available" resource that would otherwise cause benefits to cease.

C. Why a Special Needs Trust Works.

The funds of the Special Needs Trust are used to supplement and enhance the beneficiary's quality of life. Because other resources for the child are available, funds may remain at the child's death, and these funds can be directed to a charity as well as to other family members. These might include one or more of the charities that were important to the family of that child.

This is a much better approach than a traditional type of support trust for the child, which is generally treated as a resource to the child by Medicaid and Social Security, stopping benefits. Not so with a Special Needs Trust.

For this planning to work effectively, the Special Needs Trust must be created by someone other than the trust beneficiary, and it should contain only funds of persons other than the trust beneficiary. In other words, a child's inheritance should not come to him and then be transferred to this Trust—the inheritance should be directed straight to the trustee of the Special Needs Trust.

D. Using a Charitable Lead Trust.

When the benefactor's goal is to replenish a Special Needs Trust at some point in the future, a charitable lead trust may be ideal. Multiple charitable lead trusts, with staggered terms could replenish a Special Needs Trust throughout the future.

E. Using a Charitable Remainder Trust: Rev. Ruling 2002-20.

Another option for persons who desire to benefit a charity and also to provide for a special needs beneficiary is to establish a Charitable Remainder Trust that makes specified distributions to a Special Needs Trust for the trust beneficiary's lifetime. Upon the death of the person with disabilities, the trust assets are distributed to one or more charities.

An income tax charitable deduction and a gift or estate tax deduction is allowed for the value of the charity's remainder interest.

The Internal Revenue Service provided guidance and certainty about the results of this type of planning in Revenue Ruling 2002-20. See Section IV and Exhibit "A."

Normally, a Charitable Remainder Trust may only make payments to an individual, or to another trust for a limit of 20 years. However, when the payments are made to a qualifying Special Needs Trust from the Charitable Remainder Trust, they may continue for the trust beneficiary's entire lifetime. This ruling enhances the importance and use of Special Needs Trusts in estate planning.

What a positive way to combine benefits for a special needs child for life and benefits for the charities that are important in that child's life.

Note from the Program Chair, Katherine Barr:

I encourage my colleagues to continue in this creative planning and to share their ideas and enhancements with me at kbarr@sirote.com, and with Renée Lovelace at RCLovelace@aol.com. It is going to take all of us, working together, to fine tune and then fully use this approach to planning.

II. Building Blocks for Charitable + Special Needs Planning

*Remaining sections of the paper
By Renée Lovelace*

The attorney setting out to help clients further their charitable objectives while providing benefits to a child (or other beneficiary) with disabilities must have a significant amount of knowledge in a number of areas.

There is not just one complex area here, but entire fields that the drafting attorney must master—or co-counsel with another attorney who has mastered—in order to weave together special needs and charitable plans. Thus this paper does not have a sequential flow. That is because the drafting attorney must know or have access to all the planning components at one time. Key components of this type of planning include:

Trusts

Trust drafting, administration,
taxation

Life versus remainder beneficiary
interests

Investments and management

Trustees

How to select, advise, and remove

Tax impact on trustees who are
remainder beneficiaries and who
have discretion over distributions

Trustee control vs. the Trustee's
relationship with the beneficiary

Rev. Rul. 2002-20

Specifics of the ruling and the
opportunities presented

Charitable Trust options, including
Charitable Remainder Trusts,
Charitable Lead Trusts, and the
uni-trust and annuity trust options

See page 6 and
Exhibits "A" and "B"

Special Needs Trusts

Types of Special Needs Trusts

How a Special Needs Trust (SNT) is
different from other trusts

Opportunities to use SNTs

The differences between self-settled
and third-party SNTs

See page 9 and Exhibit "C"

Trust Protectors and Trustee Appointers

Why these roles have unusual significance for SNTs

See page 14

OBRA '93 and the FCIA

How OBRA '93 changed the rules for trusts for Medicaid recipients

How the Foster Care Independence Act changed the rules for SSI recipients

See Exhibit "D"

Public Benefits

How the different public benefits programs impact SNT drafting and administration.

Understanding the different requirements for the different public benefits programs—including the (1) resource, (2) income, (3) transfer/trust, (4) disability, and (5) residency/citizenship requirements

See page 16 and Exhibits "E" - "H"

Disabilities

What types of disabilities are typically tied to different public benefits programs and different ages

What the beneficiary's type of disability means to special needs planning, drafting, and administration due to different housing, employment, independent living, and other options

See Exhibits "I" - "O"

This article will address the following:

- ◆ The Basics of Special Needs Trusts
- ◆ The Basics of Public Benefits
- ◆ The Current Market of Consumer Needs and Objectives
- ◆ The Ultimate Objective: Protecting Care by Leveraging People, Paper, and Money
- ◆ Charitable Trust Options
- ◆ Rev. Rul. 2002-20
- ◆ The Role for Pooled Trusts

III. Before Revenue Ruling 2002-20

Before Rev. Rul. 2002-20, the guidance on distributions from a charitable remainder trust to a Special Needs Trust was found in Rev. Rul. 76-270, 1976-2 CB 194. There were problems with that ruling, including the requirement that the trust beneficiary be “incompetent” and that the income be used for the trust beneficiary’s support.

A. Why Advocates for Persons with Disabilities Wanted a Ruling.

Drafters tried to draft around these problems—*note the example in Section V of this article*, but all too often attorneys determined that the lack of clarity or the restrictions were too uncomfortable. Thus the CRT / SNT combination was arguably underused. Many attorneys and organizations petitioned the IRS to change their position and permit broader use of the CRT / SNT combination.

Several years before Rev. Rul. 2002-20 was released, NAMI (the National Alliance for the Mentally Ill) and several other charities based in Washington, D.C., began discussions with the I.R.S. requesting changes that would be more favorable to both charities and families, by permitting discretionary distributions rather than potentially disqualifying mandatory distributions and changing the description of the beneficiary from “incompetent” to a more flexible definition based on disability.

B. The Mission: An Improved Ruling.

NAMI staffer Winsome Clarke, along with representatives from other charities, petitioned the I.R.S. and was successful in obtaining a review. This author volunteered on behalf of NAMI, arguing that there was no need for references that intersected with Medicaid provisions.

The final ruling was not as flexible and useful as Ms. Clarke, this author, and others who had worked on this mission (including James Zartman, now retired from Chapman and Cutler in Chicago) had hoped it would be. But Rev. Rul. 2002-20 is a significant improvement that has created many opportunities for improved planning.

IV. Revenue Ruling 2002-20

Rev. Ruling 2002-20 provides that CRT distributions can be made to a second trust, such as an SNT, for the life of an individual who is “financially disabled.” See Exhibit “A” for the full text of Rev. Rul. 2002-20.

A. Question Presented.

Rev. Rul. 2002-20 presents the following question:

“May a trust qualify as a charitable remainder unitrust under § 664 of the Internal Revenue Code, if the unitrust amounts are paid to a separate trust for the life of an individual who is “financially disabled,” as defined in § 6511(h)(2)(A)?”

B. “Financially Disabled.”

§ 6511(h)(2)(A) states:

“An individual is financially disabled if such individual is unable to manage his financial affairs by reason of a medically determinable physical or mental impairment of the individual which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.

An individual shall not be considered to have such an impairment unless proof of the existence thereof is furnished in such form and manner as the Secretary may require.”

C. Three Cases Presented in the Revenue Ruling.

There are three situations outlined in the Revenue Ruling.

(1) Mandatory Monthly Amount Paid.

In the Revenue Ruling, paragraph [3], the following facts are described as “**Situation 1.**”

“Under the governing instrument of Trust B, a designated portion of the amount it receives from Trust A will be paid to C each month.

If, at any time in the sole judgment of the trustee, the monthly payment to C is insufficient to provide adequately for the care, support, and maintenance of C, or is insufficient for the needs of C for any reason, additional amounts will be paid as needed to or on behalf of C from Trust B.

Upon C's death, the balance remaining in Trust B will be distributed to C's estate.”

(2) Discretionary Special Needs Distributions; Balance to Beneficiary’s Estate.

In the Revenue Ruling, paragraph [4], the following facts are described as “**Situation 2.**”

“Under the governing instrument of Trust B, the trustee may make distributions of income and principal, as determined in the trustee's sole and absolute discretion, for the financial aid and best interests of C in a manner that supplements but does not supplant any governmental benefits otherwise available to C.

Upon C's death, the balance remaining in Trust B will be distributed to C's estate.”

(3) Discretionary Special Needs Distributions; “Pay-Back” At Death.

In the Revenue Ruling, paragraph [5], the following facts are described as “**Situation 3.**”

“Under the governing instrument of Trust B, the trustee may make distributions of income and principal, as determined in the trustee's sole and absolute discretion, for the financial aid and best interests of C in a manner that supplements but does not supplant any governmental benefits otherwise available to C.

Upon C's death, the governing instrument requires the trustee to reimburse the state for the total costs of medical assistance provided to C under the state's Medicaid plan.

C is given a testamentary general power of appointment over the balance remaining in Trust B.

If C fails to exercise the power, the balance will be distributed, in equal shares, to C's sister and to X, a charitable organization.”

D. Utility of the Options.

Circumstances in which to use the steps in either “Situation 1” or “Situation 3” will likely not arise often. The options for using “Situation 2” are plentiful.

Although the advocates were disappointed that there was not a scenario in which the balance of the funds in Trust B could be distributed to remainder beneficiaries, therefore avoiding a probate and possible State estate recovery, the ability to preserve care funds during the beneficiary’s lifetime and benefit the charity at death is a very attractive option.

V. Creative Charitable Planning + Special Needs Planning Example

The author thanks Stuart Morris, of Elder Law Associates, PA, West Palm Beach, Florida, for his work in an article presented at the 2002 Stetson University Law School Special Needs Trust Seminar in Atlanta, Georgia, from which the information below was obtained.

PLR 199903001. The grantor created a revocable trust in 1987 and transferred her personal residence and other property to the trust. Under the plan, she was the trustee of the trust until her death, at which time the trust became irrevocable. After the grantor's death, a one-half undivided interest in the residence was distributed outright to the charity (Charity) and a life estate in the other half interest was distributed to an SNT for the life of her child. The remainder interest in this one-half interest was distributed outright to the Charity at the child's death.

In the trust agreement, the Grantor requested but did not require that after her death the trustee of the SNT and the Charity enter into a "use agreement" covering the residence. The use agreement provided that, during the child's lifetime, the child would have complete use of the first floor, the back yard, and the pool located in the back yard, as well as access to the second floor for any reasonable purpose with the consent of the charity. The Charity would have complete use of the second floor and access to the first floor for any reasonable purpose with the consent of the SNT trustee.

After the grantor's death, any other property remaining in the trust would be distributed to a charitable remainder annuity trust which would be established after the grantor's death. At the death of the child, the charitable trust would terminate and the remainder interest be distributed to Charity.

The SNT was established after the grantor's death for the lifetime of the child, who is totally and permanently disabled. The stated purpose of the trust is to provide financial aid to supplement, rather than to replace, the public benefits provided to the child.

The trustee has the sole discretion to distribute income and principal to the child. The child has a general power of appointment over the trust assets. If the child fails to exercise the general power, the balance of the SNT is to be distributed to the Charity when the trust terminates.

Pursuant to the PLR, the SNT will receive and administer payments from the charitable trust for the child's benefit. Accordingly, the payments will be paid to a named person or persons within the meaning of Section 1.664-2(a)(3). In addition, in the present case, Child has a general power of appointment over the assets of the SNT. Thus, the assets of the trust will be includable in the child's gross estate. Therefore, the payment of the annuity to the SNT will not disqualify the charitable trust as a charitable remainder annuity trust under Section 664.

VI. Basics of Special Needs Trusts

Practice Note: After reading this Section VI and then reading Section VII, it will likely be helpful to re-read this Section VI. Like the classic “chicken and egg,” these two sections must be read in sequence—from both directions.

- This section covers:
- ◆ Definition of a Special Needs Trust
 - ◆ Objective: Protect Public Benefits
 - ◆ Objective: Protect the Trust Beneficiary
 - ◆ The “Pay-Back” Requirement
 - ◆ Typical Terms of a Special Needs Trust
 - ◆ State-Specific Requirements
 - ◆ Opportunities for Planning That We Do Not Want to Miss

A. The Technical and Statutory Definitions of a Special Needs Trust.

There is no federal statutory or technical definition setting out exactly what is required in the drafting of a Special Needs Trust. Some states have statutes or regulations that provide guidance on the state definitions of Special Needs Trusts.

For a national treatise and reference, see *Third Party and Self-Created Trusts*, 3d edition, by Clifton B. Kruse, published by the ABA Section of Real Property, Probate and Trust Law. (Go to www.ABAnet.org, and select Product Code 5430436.)

See www.SpecialNeedsTrusts.com and www.Special-Needs-Trusts.org for links to state-specific information. See also www.nami.org/sneps for a Special Needs Estate Planning Guidance System, a work in progress sponsored by NAMI (The National Alliance for the Mentally Ill), that includes a state-specific database scheduled to be completed by Summer 2004.

B. Different Objectives.

(1) **Objective: Protect Public Benefits.** Special needs trusts are often used when the trust beneficiary will need to (or may in the future need to) rely upon public benefits. In protecting public benefits, the drafting attorney should ensure that:

- (a) The trust is a “non-countable resource.”
- (b) Distributions from the trust do not create “countable income.”
- (c) The establishment of the trust and the transfer of funds into the trust do not create a transfer penalty.

See Section VII of this article for basic information on public benefits, and see Exhibit “E” for a summary chart on key public benefits programs.

(2) Objective: Protect the Beneficiary. It is unnecessary and may be harmful to sacrifice flexibility and a focus on the beneficiary in order to protect public benefits that a beneficiary does not even need. It is imperative to start first with a focus on protecting the beneficiary’s quality of life—especially his or her choices—whenever possible. This objective will often require that the attorney assess and/or analyze the following:

- (a)** The beneficiary’s personal circumstances
- (b)** The beneficiary’s type of disability and related needs
- (c)** The beneficiary’s objectives and desires
- (d)** The beneficiary’s capabilities for working and for living independently
- (e)** The source, amount, and type of funds
- (f)** The source, amount, and type of family, community, and other “people” assistance that is available.
- (g)** Other significant factors that will impact how the available funds can best be deployed over the individual’s lifetime to best promote the individual’s quality of life.

Use resources such as the Basic Information Needed to Start Planning (Exhibit “J”) to begin gathering information on the beneficiary. *Remember:* Special Needs Trusts are often critical to bridge the gap between the individual’s living costs and their access to funds. If individuals who are aging or who have disabilities are to have a life that includes:

- Housing
- Transportation
- Access to adequate medical care
- Comfort and quality
- Employment opportunities (*where appropriate*)

then they almost must have two critical components in their lives:

- #1** A Special Needs Trust to subsidize expenses, and
- #2** Continued eligibility for Medicaid (or other medical care)

C. The “Pay-Back” Requirement.

See Exhibit “C” for a short tutorial on Special Needs Trusts. In general, watch for these factors.

(1) First-Party vs. Third-Party vs. Quasi-Second-Party Trusts. It is critical to recognize the difference between first-party and third party trusts—and to recognize that there is another, “second-party” type of trust.

(a) First-Party or Self-Settled Trusts. In addition to the basic SNT provisions (discussed below), first-party trusts will generally require a “Pay-Back” to the State to keep the trust from counting as a resource to the trust beneficiary.

The “Pay-Back” is a provision under federal law providing that, in exchange for the beneficiary’s funds being held for the beneficiary’s use without counting as a disqualifying resource during the beneficiary’s life, that at the beneficiary’s death—prior to distributions to any other beneficiaries—the State is repaid for qualifying Medicaid benefits paid to the beneficiary. 42 U.S.C. 1396p(d)(4).

There is also the possibility of a “Pay-Over” to a pooled trust. 42 U.S.C. 1396p(d)(4)(C).

There are also requirements that certain liens be repaid before funding first-party trusts; *trusts for personal injury settlements and the special rules and requirements for those trusts are not addressed in this article.*

(b) Third-Party Trusts. If a trust is a third-party trust created with third-party money (and not the beneficiary’s money given to the third party), then:

A Pay-Back is not required.

Many attorneys have made the mistake of putting an unnecessary pay-back in third-party trusts. The State then will likely become an unintended remainder beneficiary, pre-empting the grantor’s intended beneficiaries.

(c) “Second-Party” Trusts. There are trusts that are neither true first-party trusts nor true third-party trusts. For example:

(1) Parents Creating Trusts for Dependent Children. Many public benefits programs deem a parent’s resources and income to his or her minor dependent children. Such deeming no longer applies after the child turns 18, but it is often difficult for a minor child living at home with his or her parents to qualify for public benefits programs such as SSI and certain of the Medicaid programs due to the parents’ deemed income or deemed resources. In families where parents continue to work, the parents’ income will often disqualify the child from such benefits. But if parents do not have disqualifying income, they may be able to secure public

