

Planning for beneficiaries with special needs

In brief

PROTECTING ELIGIBILITY FOR GOVERNMENT BENEFITS

Estate planning includes deciding to whom, and how, your assets will transfer upon your death. This planning takes on additional importance when one of your beneficiaries is an individual with special needs, as the receipt of assets might affect that person's eligibility for government benefits.

Developing a special needs plan is not straightforward, as there is no single solution that works for each person's unique situation. That is why it is essential for the individual or family to build a team of professionals to guide them through the special needs planning process. This team consists of: (1) a local elder law attorney or estate planning attorney who understands special needs planning, (2) a local CPA, (3) a government benefits specialist (such as National Care Advisors),¹ (4) a knowledgeable individual or corporate trustee, and (5) a financial advisor who works in the special needs market and understands how financial products and services can help make a special needs plan succeed.

Medicaid and SSI

- The two major government programs for people with special needs are Supplemental Security Income (SSI) and Medicaid (also called Title XIX).
- SSI is the basic federal safety net program for the elderly, blind, and disabled who have little or no income, providing cash to meet the basic needs of food, clothing, and shelter. While the SSI program is administered by the Social Security Administration, eligibility for SSI benefits is based on a qualified disability and financial need, not work history.
- Medicaid is also a means-tested program, paying for health services and long-term care for qualifying adults and children with disabilities.

Means-tested programs

- Medicaid and SSI are "means-tested," meaning the poorer the person is, the more likely he or she is to be eligible.
- The asset and income eligibility limits for both programs are strict. An individual applying for SSI generally cannot have more than \$2,000 in countable assets. See 20 Code of Federal Regulations § 416.1205(c). The asset limit for Medicaid is similarly restrictive, but can vary slightly from state to state. In most states, SSI recipients are automatically eligible to receive Medicaid, and it is often access to Medicaid that motivates an individual to apply for SSI.

¹ A company like National Care Advisors or a certified life care planner can help identify government benefits an individual with special needs may be eligible for and how to access and preserve those benefits as well as funding sources that can cover those expenses and identify any gaps or shortfalls that may exist.

- Providing for a person with special needs often involves structuring ownership of assets and other resources in such a way that they are considered unavailable to that individual and not counted toward the eligibility limit.
- Specially drafted trusts, known as Special Needs Trusts or Supplemental Needs Trusts (SNTs), are often used to enable a beneficiary with special needs to enjoy the use of trust property, while allowing the beneficiary to qualify for means-tested public benefits.
 - SNTs are divided into two broad categories based on the source of the funds that go into the trust. If the funds come from the loved one with special needs, it is called a first-party special needs trust (or "self-settled" trust or "payback" trust). If someone else funds the trust, it is called a third-party special needs trust.
 - The provisions creating an SNT can be put into many types of trusts, including an irrevocable life insurance trust (ILIT) or a testamentary trust created under someone's will.

ASSETS PROVIDED BY INDIVIDUAL WITH SPECIAL NEEDS

A person with special needs can acquire assets in many unexpected ways, including through an inheritance or personal injury legal settlement. Structuring these funds so that the recipient can use the money without risking disqualification from public benefits programs requires careful planning. Please note: these techniques require input from an experienced elder law attorney or special needs estate planning attorney, as the rules are complicated and vary by location.

Spend down the assets

- If the amount of money is small, it might be possible to spend the assets quickly.
- After a person applies for benefits, he or she has a certain limited time period to spend excess resources. He or she can prepay for certain services or use money to buy assets that are not counted ("exempt assets"), such as personal and household goods, tuition, home improvements, an automobile, prepaid funeral expenses, and burial plots.
- Making gifts or transferring assets for less than fair market value is considered a "divestment" and could result in disqualification for benefits.

First-party Special Needs Trust ("self-settled" trust)

- Assets that are owned by the person with special needs can be transferred to a "self-settled" or "payback" trust that will benefit him or her during his or her life. Assets in the trust are considered unavailable and are not counted for purposes of eligibility for public benefit programs.
- A first-party special needs trust must be established by the special needs individual, a parent, a grandparent, a guardian, or a court. 42 United States Code (U.S.C.) § 1396p(d)(4)(A). The trust can only be created for an individual under age 65, and that individual must have a disability as defined under the Social Security Act.
- Disbursements from the trust are generally used to supplement government benefits by paying for items not otherwise being paid for or provided.
- A first-party special needs trust must benefit that individual only.
- Any funds remaining in the first-party special needs trust at the beneficiary's death must first be tendered to the state to pay back the amount of government assistance received (the "payback" provision).

- A “pooled special needs trust” is a special kind of first-party special needs trust arrangement established by a nonprofit organization that manages and invests funds for a group of individuals with disabilities. 42 U.S.C. § 1396p(d)(4)(C).
 - The pooled trust operates as a master trust, with a separate sub-trust maintained for each individual beneficiary. Each sub-trust qualifies as a first-party trust. A sub-trust can be established by a parent, grandparent, guardian, court, beneficiary, or beneficiary’s agent under a financial power of attorney. The funds are used to purchase goods and services that will enhance the quality of life of the beneficiary, while protecting means-tested government benefits.
 - Trust funds are “pooled” together for investment purposes, offering lower administrative fees and the potential for greater growth opportunity. Because the funds are pooled, these trusts can be funded with smaller amounts, allowing those with more modest means greater access to investment opportunities.
 - The legal document to join a pooled trust is known as the joinder agreement, which allows the nonprofit to create a sub-account for each beneficiary in order to disburse funds. The joinder agreement dictates the trust’s terms, limiting the need to work with an attorney to request disbursements.
 - The assets remaining in a sub-trust of a pooled trust at the beneficiary’s death must be tendered to the state to pay back the assistance provided. In some states, the funds can stay in the master trust for the benefit of other pooled trust beneficiaries.

ASSETS PROVIDED BY THIRD PARTY

The transfer of assets by parents, grandparents, or others directly to a person with special needs may hurt eligibility for means-tested government benefits. To preserve eligibility, it is generally wiser to create a third-party special needs trust to receive gifts or bequests, rather than making outright gifts or bequests to the beneficiary.

Third-party Special Needs Trust

- The third-party special needs trust must be created by someone other than the beneficiary with special needs, and all contributions must come from someone other than that beneficiary.
- The trust can be established during the third party’s lifetime, or it can be created at death under a will. If an irrevocable special needs trust is created during lifetime, it can receive gifts or bequests from others (but not from the loved one with special needs).
- The age of the beneficiary is not a factor in the creation of these trusts.
- The trust is designed so that the trustee does not have a mandatory requirement to make distributions to the special needs beneficiary – doing so could reduce eligibility for government benefits. Instead, the trustee has discretion over the amount and frequency of trust distributions (and these can be made to pay for goods and services only; distributions of cash to the beneficiary are not allowed).
- Upon the death of the beneficiary with special needs, any remaining assets are distributed to the remainder beneficiaries, as set out in the trust document. The remainder beneficiaries could be other siblings or a charity, for example.
- There is no “payback” requirement to reimburse the state.

SPECIAL NEEDS TRUSTS: THE DISTRIBUTION PROCESS

For both first-party and third-party special needs trusts, distributions must be made for the exclusive benefit of the trust beneficiary. And although the funding sources for these two trusts are different, both trusts generally follow the same restrictions for permitted distributions.

The following distributions are typically permitted:

- Clothing;
- Computer hardware and software;
- Education, tuition, books or transportation to receive education;
- Entertainment, magazine subscriptions, recreation tickets, cable television and telephone service;
- Medical, nursing, and dental care not covered by another source; and
- Vacation expenses, including transportation and hotel.

The following distributions are generally not permitted:

- Cash given directly to the beneficiary for any purpose (including gift cards);
- Cigarettes or alcohol;
- Food or groceries;
- Gifts; and
- Housing-related payments, such as rent, mortgage payments, property taxes, heating fuel (gas or oil), electricity, water, or sewer. (In some cases, the trust may be able to pay housing expenses with only a small reduction in SSI payments.)

SPECIAL NEEDS TRUSTS: TAX BASICS

Income tax consequences of first-party SNTs

For income tax purposes, a first-party special needs trust is generally taxed as a “grantor trust” with respect to the beneficiary during his or her lifetime. In the context of a first-party SNT, the trust beneficiary is generally considered the grantor of the trust, even if he or she was not the actual creator of the trust.

A first-party SNT being classified as a grantor trust means that any income, deductions, and credits generated by the trust are reflected on the personal income tax return of the beneficiary with the disability.

Income tax consequences of third-party SNTs

For income tax purposes, a third-party special needs trust established during the lifetime of the grantor (inter vivos trust) can be classified as either a grantor trust or a non-grantor trust. The classification is based on the terms of the trust. If classified as a grantor trust, then the trust income and expenses are reported by the grantor on his or her income tax return, and not by the trust or the trust beneficiaries.

However, a third-party special needs trust created at death under a will (testamentary trust) is taxed as a separate entity from the grantor. In other words, the trust will be treated as a non-grantor trust. This means that income will be taxed to the recipient of the income. If the income is not distributed in a calendar year, then the trust will be responsible for the tax at trust income tax rates, which are generally higher than individual income tax rates.

Consideration should be given to the income tax rate applicable to a trust and to an individual, and whether income will be taxed at the trust level or to the grantor, because the difference may lead to considerable tax savings depending on how the trustee administers the trust.

COMPARISON OF SPECIAL NEEDS TRUSTS

	FIRST-PARTY TRUST	THIRD-PARTY TRUST
Assets funding the trust	Beneficiary's own assets	Assets from anyone other than the beneficiary
Established by	Special needs individual, parent, grandparent, guardian or court	Anyone other than the beneficiary
Age of beneficiary	Under 65	Any age
Can it be revocable?	No	Yes
Can it be testamentary?	No	Yes
Payback requirement?	Yes	No
Who is income taxed?	Beneficiary	Grantor trust: grantor (parent, grandparent) OR Non-grantor trust: income taxed to recipient of income

CHOOSING A TRUSTEE OF A SPECIAL NEEDS TRUST

- Special needs trusts have peculiar and strict rules that the trustee must understand to avoid disqualifying the beneficiary from government benefits. For example, even if a trust is properly drafted and funded, a distribution of cash directly to the beneficiary is counted as income even if the money is to reimburse the beneficiary for an authorized expense.
- If the trustee is an individual (e.g., a parent), the trust document should anticipate the possibility that the trustee might predecease the beneficiary or simply become unable to continue as trustee (i.e., it should contain procedures that address trustee resignation and selection of a successor trustee).
- Given the trust's increased complexity and the likelihood that the trust will endure for the beneficiary's entire life, selecting a corporate trustee or co-trustee might be warranted.

The trustee is also responsible for filing any income tax return when trust income is reportable by the SNT and taxed at the SNT level. This is another reason that a corporate trustee likely makes sense, unless the non-corporate trustee specializes in the income taxation of special needs trusts.

LIFE INSURANCE IN SPECIAL NEEDS PLANNING

- Individuals with special needs are often taken care of by their parents. This might work while the parents are alive but raises the question of what to do after the parents pass away.
- Without parents around as caregivers or as a source of funds, it is often uncertain how the individual with special needs will be able to carry out activities of daily living or pay for professional care. Siblings are often unable to fill the gap.
- Life insurance can provide funds at a parent's death to help pay for caregivers or other resources that can maintain the quality of life for the person with special needs. Many parents will use second-to-die life insurance that provides resources to fund a special needs trust at the second death.

Who should own the policy?

- The policyowner should not be the person with special needs (or his or her revocable trust).
- The policyowner could be nearly anyone else, including a parent or a trust. If the owner is an irrevocable trust, the special needs beneficiary should not have a right to withdraw annual gifts made to the trust (this right, known as a "Crummey power," is a countable asset and letting it lapse is considered a divestment).

Who should be the beneficiary of the policy?

- It is safest to name a properly drafted third-party special needs trust as the policy's beneficiary. This assures that the death proceeds will be available to enhance the quality of life of the loved one with special needs, while preserving eligibility for public benefits.
- The loved one with special needs should not be the direct beneficiary of the life insurance, as the death proceeds would be a countable asset. If the beneficiary does receive the death benefit, legal assistance should be obtained to consider putting the funds in a first-party special needs trust.
- A sibling generally should not be named as beneficiary. The sibling might not use the money for its intended purpose or might have creditors that could attach the funds. Even if the sibling gives the money to the person with special needs, this could render him or her too wealthy to obtain government benefits.

ANOTHER OPTION: 529A ABLE ACCOUNTS

In general

ABLE accounts (taking their name from the Achieving a Better Life Experience Act of 2014) work very similarly to 529 education accounts. Cash contributions can be made, the investments grow tax deferred, and distributions for qualified disability expenses will be tax free.

These accounts are best for high-functioning special needs individuals who want their own financial independence. ABLE accounts allow them to earn, save, and spend their own money without disqualifying themselves from disability benefits. These accounts are not for parents or family members who want to set aside large sums for the beneficiary. There are limits on how much can be contributed each year, so those family members would be better served by a third-party special needs trust.

In depth

- **Eligibility.** ABLE accounts can be established for beneficiaries who became blind or disabled before age 26. Beneficiaries can be over age 26, but the onset of their disability or blindness must have occurred before age 26; for tax years after December 31, 2025, the age limit will increase to age 46, under the SECURE 2.0 Act of 2022. The beneficiary must be entitled to benefits under the Supplemental Security Income (SSI) or Social Security Disability Insurance (SSDI) programs. They do not actually need to be receiving these benefits, but if they are, that can be used to prove the disability. Otherwise, they must certify under penalty of perjury that they have obtained medical documentation of their disability from a physician.
- **Choosing a program.** 529A ABLE account programs are established by the states. People looking to establish an account can shop around state programs to choose what is best for them.
- **Contributions and overall account limit.** Contributions must be made in cash. Anybody can contribute, including the beneficiary. The total amount of contributions from all contributors each year cannot exceed the annual gift exclusion (\$17,000 in 2023). This limitation is why ABLE accounts do not make effective estate planning vehicles. Some states may allow for state income tax deductions for contributions. In addition, if a beneficiary is receiving SSI, the total account balance allowed in an ABLE account is \$100,000.
- **Investments.** Account owners are typically given a menu of investment options by the state program. If somebody is looking to establish an ABLE account and they do not like the state's investment options, they can look to establish an account in another state.
- **Distributions.** Distributions that are used for "qualified disability expenses" are tax free. Qualified disability expenses include expenses for the beneficiary related to their blindness or disability, including expenses for education, housing, transportation, employment training, personal support services, prevention and wellness, financial management services, legal fees, and funeral expenses. The IRS and Treasury Department have commented in the preamble to tax regulations on ABLE accounts that these accounts are meant to be used for expenses that help improve health, independence, and/or quality of life. If a distribution is not used for a qualified disability expense, then earnings will be taxed with a 10% penalty.
- **Medicaid repayment.** After the beneficiary passes away, any remaining amounts in the account are subject to Medicaid estate recovery rules. After that, any remaining funds can be left to a designated beneficiary.
- **Rollover from 529 education account.** Funds in a 529 education account can be rolled into a 529A ABLE account for the same beneficiary tax free. These rollovers count towards and are subject to the annual exclusion limitation for all contributions for the year.
- **Using a 529A ABLE account with a Special Needs Trust.** Keep in mind that you do not need to choose between an ABLE account and a special needs trust. If both are appropriate for the individual situation, you can have both. The ABLE account balance cannot exceed \$100,000 or the individual with special needs risks losing benefits, so using an ABLE account in addition to an SNT allows you to put a relatively smaller amount in the ABLE account to provide for a wide range of uses, including housing and food. Some state programs even allow debit cards for access to funds, so the beneficiary can make purchases independently without requesting funds from the trustee.

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