UNDERSTANDING SPECIAL NEEDS TRUSTS

2023 Seminar Material

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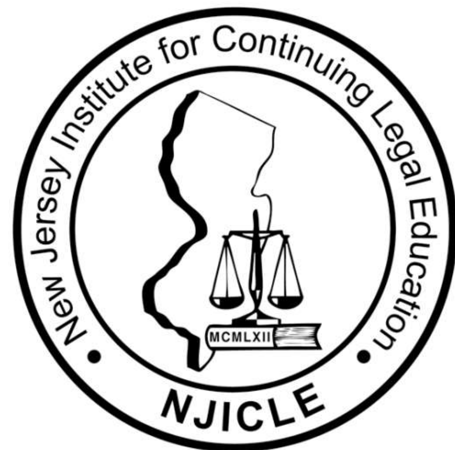

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UNDERSTANDING SPECIAL NEEDS TRUSTS

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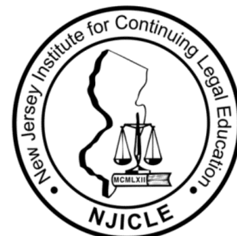

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Understanding SNT's – first-party vs. third-party SNT's
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1

- There are a lot of misconceptions about special needs trusts (SNT's)… even among lawyers
- There are a lot of misconceptions about trusts, forget the special needs part

2

- What is a trust?
- A trust is a contractual relationship between a grantor and trustee
- Grantor gives money to trustee to hold in trust for beneficiary

3

- Where does the special needs part come in?
- SNT is a type of trust meant to protect a person with disabilities, a person with special needs
- Person with disabilities is the beneficiary

4

- Why would you need a SNT? Usually it's to protect eligibility for disability benefits
- People with disabilities can qualify for disability benefits, public assistance programs provided by the government

5

- Most common disability benefits…
- Supplemental Security Income (SSI) – cash assistance program that pays around $750 per month
- Medicaid – government health insurance program with almost no costs

6

- Section 8 Housing – subsidized housing and vouchers
- SNAP – food assistance

7

- Social Security Disability Insurance (SSD or SSDI) – monthly cash program that pays based on work history (yours or a family member's)
- Medicare – government health insurance program with more costs than Medicaid, but more options sometimes

8

- Some of the most important disability benefits programs are means-tested
- Means-tested means that to qualify, you must have less than a certain amount of assets and income

9

- Some programs aren’t means-tested – SSD and Medicare are based on your work history (or a family member’s work history)

10

- SSI and Medicaid are means-tested
- There’s a bunch of different programs with different rules, but for the most common program, you must have less than $2,000 in assets to qualify for SSI and Medicaid

11

- So if someone is getting SSI and Medicaid, and they get some pot of money, such as an inheritance, or personal injury recovery, or gift from family, or something else…
- They’ll probably lose their benefits

12

- Losing benefits can be very problematic
- Medicaid can pay for important programs, such as day programs, group housing, long term care, etc.
- If you lose benefits, it can be very difficult to get back on

13

- Instead, the best practice much of the time is for that money to go to SNT
- Purpose of SNT is to set that money aside, available to meet the person's needs, while not counting against that asset limit and disqualifying person from benefits

14

- Idea is that benefits meet basic needs, and trust is available for special needs (although that's not always realistic, especially in NJ with cost of living)

15

- Also general trust purpose – a lot of times, person with disabilities (beneficiary) can't manage trust assets, so this allows another person (trustee) to manage investments, decide how to spend it, deal with taxes, etc.

16

- There are two main types of special needs trust
- First-party SNT
- Third-party SNT
- Different rules for each, important not to mix them up!

17

- First-party – the money is coming from the person with disabilities – the grantor is the beneficiary (or someone acting on behalf of beneficiary)
- Third-party – the money is coming from someone other than the person with disabilities – grantor and beneficiary are different people

18

- If you think back to grammar school…
- First party = I (I put my money in the trust)
- Third party = They (they put their money in the trust)

19

- Most common first-party trust scenario is where person with disabilities gets money as a result of lawsuit – e.g., personal injury lawsuit settlement from accident that led to disability
- Money is payable to person with disabilities, so it's first-party (I put my money in trust)

20

- Most common third-party trust scenario is where parents are leaving money to benefit child with disabilities as part of their estate plan
- In their will, instead of leaving share to child, they leave it to SNT
- Money is coming from parents, so it's a third-party (they put their money in trust)

21

- Sometimes people neglect to do this type of estate planning, or forget to change retirement account beneficiary designations, or something similar
- In that case, money is payable directly to person with disabilities, and a first-party SNT is probably needed

22

- In general, it's preferable for money to go into a third-party SNT rather than a first-party SNT
- There are a lot of rules that apply to first-party SNT, that don't apply to third-party SNT

23

- Biggest issue is probably that a first-party SNT has to repay the government when the beneficiary passes away for any Medicaid assistance that the government provided to the beneficiary during the beneficiary's lifetime

24

- If the beneficiary gets Medicaid for any length of time, this Medicaid lien is usually a large amount
- NJ Medicaid is semi-privatized, administered by private companies called managed care organization, or MCO (such as Horizon NJ Health)
- State pays a monthly capitated rate to MCO (similar to health insurance premium)

25

- So even if person doesn't use extensive services, capitated rate adds up
- Bottom line is that if beneficiary gets Medicaid, first-party trust will probably have to make a big repayment to the state when the beneficiary passes away. Usually isn't any money left for remainder beneficiaries.

26

- First-party trust has Medicaid payback requirement
- Third-party trust has no Medicaid payback requirement – no obligation to repay the state for amounts it spends on Medicaid for beneficiary
- Third-party trust should never include Medicaid payback provision

27

- First-party trust also has to comply with other rules, trustee has to follow rules while administering trust
- First-party SNT has to follow 42 USC 1396p(d)(4)(A), so these trusts are sometimes called d4A trust
- Have to comply with rules set forth in NJAC 10:71-4.11(g) (OBRA '93 provisions)

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- Have to inform Medicaid of any expenditures over $5,000 (they probably won't reply)
- Have to account to Social Security and Medicaid each year

29

- Another big rule with first-party SNT's… distributions must be for sole benefit of beneficiary
- Trust can't benefit anyone other than beneficiary… no gifts to third parties (including family members like children, spouse, parents)

30

- Government has taken a strict position on this in past
- For example, if trust buys a house for beneficiary to live in, and parents live in house too, parents may have to pay rent to trust
- If trust buys something that family uses (TV, pool, etc.), government may take issue if it's not primarily for beneficiary's use

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- Sole benefit rule applies to first-party SNT's
- No such rule for third-party SNT's, grantors can do whatever they want
- Third-party SNT can benefit person with disabilities and their children, etc. if grantor provides for it

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- Some other requirements for first-party SNT's
- They can only be funded before the beneficiary turns age 65
- If person is age 65 or older, cannot add principal to trust
- Person has to be disabled at time trust is established

33

- Bottom-line: First-party SNT's have to follow a bunch of onerous rules that third-party SNT's do not have to follow
- In general, where possible, it's better to put assets into third-party SNT
- But where person with disabilities already owns assets, must use a first-party SNT

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- Beneficiary (and their spouse) should never put their own money into an existing third-party SNT
- If that happens, whole third-party SNT might have to start following first-party SNT rules (be subject to Medicaid payback, etc.)

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- What do first and third-party SNT's have in common?
- Most important point – all distributions are within sole discretion of trustee
- Beneficiary has no right to withdraw from trust, right to compel distributions, right to income, etc.

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- Beneficiary has no control over trust
- Trustee decides how much to spend, what to pay for, when to pay for it
- Trustee can say no to beneficiary
- No obligation for trustee to make distribution to beneficiary under any circumstances – trustee need not support beneficiary, can leave beneficiary homeless and in crushing debt

37

- Beneficiary has no control over trust assets and cannot compel distributions, therefore trust assets and income are not considered available to beneficiary, and don't count towards eligibility limits for public benefits programs

38

- Obviously, grantor is putting a lot of trust in trustee to do the right thing
- You wouldn't want to really leave the beneficiary homeless and in crushing debt
- It's important to appoint a trustee who grantor trusts, who will act in beneficiary's best interests and take responsibilities seriously

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- Usually this would be either a family member (but not spouse)
- ...or a professional trustee, such as a bank's trust department

40

- Trustee is entitled to take an annual fee by statute – 6% of income, 0.5% of corpus
- Family members often do not take the fee (even though being trustee can be a lot of work)
- Professional trustees often take a higher fee than the statutory rate – trust agreement should allow for this (or you may not be able to find a professional trustee if it becomes necessary)

41

- A lot of banks don't want to serve as trustee for SNT, seeing the job as overly complicated, unless there's a lot of money in trust (generally $1mm+, sometimes several million plus)
- Some smaller local companies have lower limits

42

- Having a professional trustee allows for professional money management (trustee makes all investment decisions), handling of taxes, etc.
- Also can be other benefits – it can be easier for a bank to say no to the beneficiary than a family member

43

- Sometimes we recommend a professional trustee if family tension seems likely with a family member trustee
- This comes up especially where beneficiary is disabled due to mental health issues
- Beneficiary may have wherewithal to ask for unreasonable things, but not recognize they're unreasonable, and get mad at trustee for saying no – it's harder to guilt-trip a bank

44

- Should a SNT be stand-alone (in a separate document), or part of a will?
- First-party SNT must be stand-alone
- Third-party SNT could be part of a will (a testamentary trust)… but I think it's a better idea for it to be stand-alone

45

- With a stand-alone trust, you can change trust without changing will (might want to change trustee, etc.)
- Also, testamentary trust only takes effect when testator dies, but stand-alone trust can take effect during grantor's lifetime
- Other family members might want to leave inheritance or make gifts to third-party trust during grantor's lifetime

46

- Also, as part of estate planning…
- Make sure clients update any beneficiary designations, especially on retirement accounts
- Third-party trust isn't effective unless property actually gets to it

47

- If client has an old beneficiary designation that leaves share directly to disabled child, and not to the spiffy third-party SNT you set up…
- Then only option may be first-party SNT (if possible)
- Estate planning should be coordinated holistically

48

- Finally, clients sometimes don't know whether they need an SNT or not
- For people with disabilities under age 18, they often don't get disability benefits yet because of parents' income and assets, but they may be eligible for benefits after age 18

49

- Also, as mentioned earlier…
- Not all assets are means-tested
- SSDI and Medicare are not means-tested
- If a person doesn't get means-tested benefits, they don't need an SNT

50

- However, they might want means-tested benefits in future
- Medicaid pays for things that Medicare doesn't pay for, including long term care
- Medicaid can supplement Medicare
- If they may want Medicaid in future, a SNT is a good idea

51

- Often, clients don't know exactly what benefits they or their loved ones receive
- They might get both Medicare and Medicaid
- They might not know if they're getting SSI or SSD
- It's important to figure this out
- If they can't manage money anyway, SNT probably makes sense regardless of what benefits they get

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- It's important to ask about these issues when meeting with clients for estate planning (is anyone in the family disabled?), personal injury or divorce (is the person getting Medicaid?), etc.

53

- Another note – there are different terms of art for SNT's
- Sometimes people in NJ refer to first-party SNT's as special needs trusts, and third-party SNT's as supplemental needs trusts
- No official terminology

54

- Finally, timing of SNT
- For first-party SNT, when should it be done?
- As early as possible
- Money counts towards person's eligibility limit once it's available to the person
- Available means it can be used to pay for food or shelter

55

- If the money is sitting in an attorney's trust account, available for the client to pick up at any time, the money is available to the client, regardless of whether the client actually picks it up
- Best practice is to set up first-party SNT before settlement is finalized, and pay money directly from attorney to trustee

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- Thank you!
- Questions?
- Mark R. Friedman – 908-391-8959
- www.SpecialNeedsNJ.com

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Ethics: Representing Clients with Diminished Capacity

By: Shirley B. Whitenack, Esq.
Schenck, Price, Smith & King, LLP
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ETHICAL CONSIDERATIONS WHEN REPRESENTING A CLIENT WITH DIMINISHED CAPACITY

A. Keeping in Tune with the Rules of Professional Conduct

1. Informed Consent. New Jersey's Rules of Professional Conduct ("RPC") governing lawyers encompass the concept of informed consent by clients. *See* RPC 1.0 (denoting "informed consent" as "the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risk of and reasonably available alternatives to the proposed course of conduct"). A threshold issue, therefore, is whether the potential client has sufficient capacity to understand and agree to the proposed representation.

2. Client Under a Disability. When dealing with the management or disposition of an estate, it is imperative for the attorney to determine who the client is and appreciate the possibility of conflicting interests. Although a client may have the requisite capacity to execute certain legal documents, he or she may have some diminished capacity. If, in connection with the representation, a client's decision making ability is impaired, New Jersey's Rules of Professional Conduct call for the lawyer to "as far as reasonably possible, maintain a normal client-lawyer relationship with the client." RPC 1.14(a). A lawyer may seek appointment of a guardian for the client or take other

protective action "only when the lawyer reasonably believes that the client cannot adequately act in the client's own interest." RPC 1.14(b).

In other states, the attorney's protective action may raise issues of attorney-client privilege, and the violation of the privilege during the guardianship proceeding. In New Jersey, attorneys may initiate a guardianship proceeding on behalf of the client where the attorney reasonably believes that the client cannot adequately act in the client's own interest, especially if the client can no longer communicate because of a mental disability such as senile dementia or Alzheimer's disease. RPC 1.14(b).

3. Confidentiality of Information. As a general rule, an attorney is prohibited by RPC 1.6 from disclosing information relating to representation of a client unless the client consents to the disclosure after consultation. The exceptions to this rule involve the prevention or rectification of a criminal, illegal or fraudulent act that the lawyer reasonably believes "is likely to result in death or substantial bodily harm or substantial injury to the financial interest or property of another" or "is likely to perpetrate a fraud upon a tribunal." In addition, RPC 1.14(c) states that a lawyer "is impliedly authorized under RPC 1.6(a)" to disclose information about the client "to the extent reasonably necessary to protect the client's interests" when the lawyer takes protective action pursuant to RPC 1.14(b).

It is common for clients with diminished capacity to be accompanied by other family members when they consult with an attorney. The attorney must ascertain whether the person is making his or her own decisions or whether those decisions are the product of undue influence. For this reason, it is prudent to speak to the person with diminished capacity outside the presence of others and confirm that the person understands the

proposed course of action and agrees to it. A person with diminished capacity may request that information pertaining to the representation be disclosed to another family member. The lawyer may do so, provided that the client understands that such disclosure may not be protected by the attorney-client privilege.

4. Settlement Negotiations. An attorney is required to abide by a client's decisions concerning the scope and objectives of the representation and must consult with the client about the means to pursue those objectives. RPC 1.2(a). Moreover, an attorney must abide by a client's decision whether to settle a matter. *Id.* Accordingly, the client must have the requisite capacity to understand the risks and benefits of settlement vs. trial.

B. Competency of the Client

1. Definition of Capacity. While the legal and medical communities tend to define the term "capacity" differently, it is agreed that capacity involves the ability to understand and process information so that a decision can be made and communicated. New Jersey law defines an "incapacitated individual" as "an individual who is impaired by reason of mental illness or mental deficiency to the extent that he lacks sufficient capacity to govern himself and manage his affairs." N.J.S.A. 3B:1-2. The statute also defines "incapacitated individual" to encompass "an individual who is impaired by reason of physical illness or disability, chronic use of drugs, chronic alcoholism or other cause (except minority) to the extent that he lacks sufficient capacity to govern himself and manage his affairs." *Id.*

2. Intellectual Disability. This term refers to "a significant subaverage general intellectual functioning existing concurrently with deficits in adaptive behavior which are manifested during the development period." N.J.S.A. 3B:1-2.

C. General Durable Power of Attorney.

A person with diminished capacity may have the requisite cognitive ability to execute a power of attorney. An attorney-in-fact may be able to prosecute or defend a litigation on behalf of the principal. The client signing a power of attorney must comprehend that he or she is placing the agent in charge of his or her affairs and the consequences of doing so. The attorney-in-fact must understand that he or she must act in the best interests of the principal.

D. Advance Directive.

1. The New Jersey Advance Directives for Health Care Act ("Living Wills") recognizes an individual's right to have life- prolonging medical or surgical procedures withheld or withdrawn. N.J.S.A. §§26:2H-53 to -78. The Act defines "decision making capacity" as "a patient's ability to understand and appreciate the nature and consequences of health care decisions, including the benefits and risks of each, and alternatives to any proposed health care, and to reach an informed decision. A patient's decision making capacity is evaluated relative to the demands of a particular health care decision." N.J.S.A. §26:2H-55.

2. A New Jersey chancery court explained that the issue of capacity to consent to or refuse a medical procedure is within the purview of the judiciary and that the test for determining a patient's mental capacity to consent to medical treatment is whether the patient has "sufficient mind to reasonably understand the condition, the

nature and effect of the proposed treatment, attendant risks in pursuing the treatment, and not pursuing the treatment." *See In re Schiller*, 148 N.J. Super. 168, 181 (Ch. Div. 1977). If there is *prima facie* evidence of mental incapacity and there is time, a general guardian should be appointed pursuant to R. 4:86-1 to -12. *Schiller,* 148 N.J. Super. at 179.

3. Separately, a New Jersey chancery court held that an advance directive executed by a woman who previously had been adjudicated to be mentally incapacitated and unable to consent to medical treatment was not binding and, therefore, was unenforceable; however, it could be used by her guardian as evidence of the woman's subjective intent. *In re Roche,* 296 N.J. Super. 583 (Ch. Div. 1996). The court stated that "once a person has been adjudicated incompetent, he or she can no longer exercise the right to execute an advance directive pursuant to the Advance Directives Act." *Id.* at 591. An incapacitated person's common law right to self-determination is the same as that of a person with capacity, except that the right of self-determination for the incapacitated person must be balanced by the court with concern for his or her best interests. *See id.* at 587 (citing *In re M.R.*, 135 N.J. 155 (1994)).

E. Wills.

1. It is well settled in New Jersey that the standard for testamentary capacity is relatively low and not difficult to satisfy. *See In re Estate of Frisch*, 250 N.J. Super. 438 (1991) (recognizing the low threshold for testamentary capacity); *see also*, *In re Wilson's Will,* 107 N.J. Eq. 604 (Prerog. Ct. 1931) (holding that a very low degree of mental capacity is sufficient). Typically, the courts look for four elements to satisfy testamentary capacity:

(1) Comprehension of the action being taken and its effect.

(2) Knowledge of the nature and extent of the testator's property.

(3) Recognition of the natural objects of the testator's bounty.

(4) Presence of the three elements at the time of the decision.

See generally, In re Phillips, 139 N.J. Eq. 257 (1947) (holding that a finding of testamentary capacity requires the testator to know the extent of his property and the natural objects of his bounty and to have a sound mind to know and understand his desired disposition of his property); *but see In re Will of Liebl*, 260 N.J. Super. 519 (App. Div. 1992), (testator's misconception of exact nature and value assets will not invalidate Will where there is no evidence of incapacity, provided testator has general estimate of value of estate).

A testator may have a mental disorder and yet still be found to have the requisite capacity to create a will. *See, e.g., Howell v. Taylor*, 50 N.J. Eq. 428 (Prerog. Ct. 1892). If, however, there has been an adjudication of incapacity such that the incapacitated person is divested of all control and management of his or her property, the incapacitated person is deemed to be unable to execute a valid will, even if that person executed the will during a lucid interval with the requisite testamentary capacity. *In re Frisch, supra*, 250 N.J. Super. at 447-48 (citing *In re Estate of Bechtold*, 150 N.J. Super. 550 (Ch. Div. 1997), *aff'd*, 156 N.J. Super. 194 (App. Div. 1978) and N.J.S.A. 3B:12-27). The court reasoned that there must be a finding of a restoration of capacity before the issue of testamentary capacity can be reached.

F. Deeds and Inter Vivos Trusts.

New Jersey law is not decisive on the issue of whether the execution of these documents requires testamentary capacity, donative capacity or contractual capacity. While a living trust may have many of the same characteristics of a contract, such a trust is often designed to avoid probate, and therefore, it is not unreasonable to argue that the standard for testamentary capacity should be applied.

G. Gift*s*.

Under New Jersey law, a valid *inter vivos* gift generally requires four elements: (1) an act constituting actual or symbolic delivery of the subject matter of the gift, (2) an intent to give, (3) an acceptance of the gift, and (4) the donor's relinquishment of ownership and dominion over the subject matter of the gift. *Pascale v. Pascale*, 113 N.J. 20, 29 (1988). The donor must understand that once the gift is made he or she does not have the right to demand the return of the gift.

H. Conservatorship

A person with diminished capacity may want court supervised surrogate management while retaining control over his or her finances because family members are in disagreement or the conservatee has no caregivers whom he or she trusts. The appointment of a conservator is governed by New Jersey statute and court rules. N.J.S.A. 3B:13A-1 *et seq.; R.*4:86-11. The action is commenced in Chancery Division, Probate Part by filing a verified complaint and order to show cause by the conservatee or other person on his or her behalf on notice.

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ETHICS: Representing Clients with Diminished Capacity

Presented By:
Shirley B. Whitenack, Esq.

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Keeping in Tune with
the Rules of Professional Conduct

- RPC 1.0 – Informed Consent
- “The agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risk of and reasonably available alternatives to the proposed course of conduct.”
- Does the potential client have sufficient capacity to understand and agree to the proposed representation?

Client Under a Disability

- RPC 1.14 – Client Under a Disability
- Even if the client has the requisite capacity to execute certain legal documents, does the client have diminished capacity?
- The lawyer must "as far as reasonably possible, maintain a normal client-lawyer relationship with the client."
- A lawyer may seek appointment of a guardian for the client or take other protective action "only when the lawyer reasonably believes that the client cannot adequately act in the client's own interest."

Confidentiality of Information

- RPC 1.6 – Lawyer is prohibited from disclosing information relating to representation of a client unless client consents after consultation.
- Exception:

  Prevention or rectification of criminal, illegal or fraudulent act that lawyer reasonably believes is "likely to result in death or substantial bodily harm or substantial injury to the financial interest or property of another" or "is likely to perpetrate a fraud upon a tribunal.

RPC 1.14 and RPC 1.6

- RPC 1.14(c) – Lawyer is impliedly authorized by RPC 1.6(a) disclose client information “to extent reasonably necessary to protect the client’s interests.”

When Client is Accompanied by Someone Else to Attorney Meeting

- Common for elderly people or people with cognitive disabilities to be accompanied by others when they consult with an attorney.
- Lawyer should consider whether the client is making his or her own decisions or whether those decisions are product of undue influence.
- Prudent to initially speak to client outside the presence of others and confirm client understands proposed course of action and agrees to it.

Disclosure to Others at Client Meeting or After

- Lawyer may disclose confidential information to others upon consent of client but client should understand that such disclosure may not be protected by the attorney-client privilege.

Conflict of Interest

- RPC 1.7 – Lawyer cannot represent client if representation is adverse to another client unless attorney believes the representation will not adversely affect representation and each client consents after full disclosure and consultation.

Why Am I left in the Waiting Room?
Understanding the Four C's of Elder Law Ethics

- American Bar Association brochure explains the “Four C’s” of elder law ethics—client identification, conflicts of interest, confidentiality, and competency.

Assessing Client's Capacity

- Lawyer should adopt procedure to assess client's mental capacity
- Ascertain best ways to communicate.
- Determine whether client is hearing and/or visually impaired
- Obtain assessment by medical and/or geriatric professionals when appropriate

Using Tests to Assess Capacity

- Mini-Mental Status Examination and other similar tests
- Should lawyer use these tools?

Protecting Client's Documents from Contest and Invalidation

- If attorney suspects there may be undue influence, meet separately with client and discuss the reasons for the proposed course of action.
- Have another attorney or legal assistant present at the meetings and document executions.
- Have the client provide documentary support for the proposed course of action.
- If possible, have the client write the reasons for the proposed course of action.

Protecting Client's Documents from Contest and Invalidation

- Make and keep notes of meetings and client discussions in the file.

Videotaping or Audiotaping Document Executions

- Should you videotape or audiotape document executions?
- Advantages: may show client's understanding and consent regarding contents of the documents
- Disadvantages: may suggest attorney has concerns regarding capacity or undue influence; client may show anxiety, making it appear that client has less capacity than he or she actually has.

Recognizing Situations Ripe for Undue Influence

- Confidential relationship
- Disinheritance or unequal shares
- Another individual asks for preparation of estate planning document favorable to that individual
- Caregivers
- Someone other than the client is doing most of the talking at the meeting
- Client overly relies on someone else to answer questions or provide information.

Working From Home

Protect Client Confidentiality

Client Documents

Telephone Conferences

Videoconferences

Data Security

Internet Security

Public or Shared WiFi networks

VPN

Staff's Personal Devices

Communications with the Client

"Who is the Client" hasn't changed

Person in Need?

Attorney-in-Fact?

Guardian?

Communicating with the Client Remotely

- Let the client tell you their wishes in their own words
- Watch out for red flags
  - Client repeats what someone else wants the client to do
  - Client relies on someone else to talk for them
  - A family member tells you with the senior wants

THANK YOU

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The Upside Down World of Estate Planning – Income Taxation "Takes Over"

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The advent of three expansive tax laws in the last sixteen (16) years – the Tax Cuts and Jobs Act of 2017 ("TCJA"), the American Taxpayer Relief Act of 2012 ("ATRA") and the Affordable Care Act of 2010 ("ACA") - have dramatically changed the landscape of estate planning. Many of the traditional concepts and techniques which have become a mainstay with respect to estate planning require additional or alternative thought. This outline will address some of the changes in the law enacted by TCJA, ATRA and ACA – most notably the income tax changes which have affected the estate planning landscape.

Obtaining basis with respect to appreciated assets will oftentimes outweigh the traditional desire to have assets excluded from the estate of a decedent. This outline will address some of the tools necessary to provide the flexibility to render such a determination as circumstances dictate.

Income tax changes in the trusts and estates arena will cause estate and tax planners who do not familiarize themselves with the application of such rules unintended and often adverse tax consequences to clients which proper planning could minimize or avoid. This outline will address the rules and the planning techniques which are available to estate and tax practitioners the proper application of which may minimize or avoid such unintended consequences.

Generally

A series of changes in the tax law effectuated by TCJA, ATRA and ACA have caused estate planners to rethink some of the basic tax planning techniques which have become a standard facet of an estate planning practice. Specifically, (i) the value of assets which are exempt from the estate, gift and generation skipping transfer tax system is substantially larger than that which was recently applicable – and those exemptions increase every year, (ii) with the adoption of Portability, married couples can easily exempt twice as much as the already substantially larger exemptions and (iii) the inclusion in the estate of most appreciated assets not subject

to the estate tax resultant from increased exemptions nonetheless retains the benefit of the elimination from income taxation any pre-death increases in value. As a result, the income tax considerations with respect to planning in many cases transcend transfer tax considerations.

The "New" Income Tax Rates

TCJA revised the income tax rates imposed by ATRA which had in turn revised the rates previously imposed by the Economic Growth, Tax Relief and Reconciliation Tax Act ("EGTRRA") – commonly known as the "Bush Tax Cuts" (Editorial Note – the best acronym they could devise was EGTRRA – come on!)

The rates enacted by TCJA are slightly lower than those which existed under ATRA – with higher limits applicable to those rates. The maximum income tax rate under TCJA is equal to 37%; ATRA and EGTRRA imposed a maximum rate equal to 39.6%. For 2023, single individuals are affected by the maximum rate on taxable income in excess of $78,175. Married taxpayers who file a joint return are subject to said rate on taxable income in excess of $693,750. Each of those amounts is indexed for inflation with a baseline of the year 2018.

The maximum income tax rate for trusts and estates becomes effective at a substantially lower amount. Specifically, trusts and estates are taxed at the 37% tax rate on all undistributed taxable income (Emphasis Added) in excess of $10,000 indexed for inflation. The limit for 2023 is equal to $14,450. As will be addressed later in the outline, the distribution of income from trusts and estates will in many circumstances provide significant income taxation savings as between the trust or estate on the one hand and the beneficiaries on the other.

To complicate matters, the provisions of TCJA which are noted above are set to expire on December 31, 2025, the result of which would be the reinstatement of ATRA. Fortunately – at least for estate planners and tax lawyers – the provisions of TCJA and ATRA with respect to the amount above which the maximum rate is imposed on trusts and estates is identical - $10,000 indexed for inflation – with a rate differential of only 2.6% (39.6% vs. 37%).

Section 1411 - The Net Investment Income Tax

The ACA enacted an additional tax at a rate equal to 3.8% with respect to net investment income. Neither TCJA nor ATRA modified the provisions of the ACA (other than indirect effects which are not relevant to the subject matter of this outline and are outside the scope of the outline).

Investment income includes a series of categories of income all of which can be generally classified as passive income. Included in the category of items subject to the tax are interest, dividends, long-term capital gains, short-term capital gains, rental income, royalty income and income from passive activities, generally equivalent to those treated as passive pursuant to Section 469 of the Internal Revenue Code ("Code") and the Treasury Regulations ("Regulations") promulgated thereunder. (Additionally included is income earned from the engagement of the business of trading in financial instruments or commodities as that term is defined in Section 475(e)(2) of the Code.)

Generally, income which is not subject to regular income tax is not subject to the Net Investment Income Tax ("NIIT"). For example, municipal bond interest treated as exempt pursuant to Section 103 of the Code is not subject to the NIIT. Similarly, income exempt pursuant to Section 121 of the Code with respect to the sale of a principal residence in an amount equal to $250,000 for single individuals and $500,000 for married taxpayers that file a joint return is not subject to the NIIT within the same limitations.

The Final Regulations related to the NIIT contain numerous examples which with limited (and rarely applicable) exceptions outside the scope of this outline apply the NIIT in a manner in which the amounts are tied to the "regular" income tax base.

Example - Taxpayer A has interest income in an amount equal to $5.000 and net capital losses in an amount equal to $5,000. The deductibility of those losses pursuant to the regular income tax system is limited to $3,000. Economically, the taxpayer had no net investment income; the interest income is offset by the net capital losses. Notwithstanding same, the Regulations render clear that for purposes of the NIIT, the taxpayer – like the "regular" tax system - has taxable net investment income in an amount equal to $2,000.

Note – The author believes that the consistency between the regular tax system and NIIT is sensible. A contrary result would require separate accounting records with

respect to each tax. In the above example, A would have a capital loss carryforward pursuant to the regular tax system but not the NIIT system if the full capital loss were permitted only for NIIT purposes. The Regulations do not allow for that – and other - inconsistencies.

The NIIT is applicable only with respect to taxpayers that have income in excess of certain amounts. Single individuals are subject to the NIIT in the event that his or her adjusted gross income ("AGI") is in an amount in excess of $200,000. The AGI limit for married taxpayers who file a joint return is in an amount in excess of $250,000. The tax is imposed with respect to the lesser of (i) the amount of net investment income or (ii) the amount by which the AGI exceeds the limit.

Example – Assume single taxpayer A has net investment income in an amount equal to $20,000 and AGI in an amount equal to $230,000. A will be subject to the NIIT with respect to all of the net investment income, since the amount of such income ($20,000) is less than the amount by which the AGI exceeds the limit ($230,000 less $200,000 = $30,000).

Assume instead A has an AGI in an amount equal to $210,000. A will be subject to the NIIT with respect to $10,000, since the amount by which the AGI exceeds the limit ($210,000 less $200,000 = $10,000) is less than the net investment income ($20,000).

Note – The AGI limits in the amount of $200,000 and $250,000 are not indexed for inflation.

The NIIT is applicable to trusts and estates at the same level as the maximum income tax rate. Accordingly, trusts and estates are subject to the NIIT on all undistributed taxable income (Emphasis Added) in excess of $10,000 indexed for inflation. As stated above, the limit indexed amount for 2023 is $14,450. Therefore, trusts and estates will be subject to a combination of the maximum income tax rate AND the NIIT with respect to undistributed taxable income in excess of the above noted limits, the combined rate of which is equal to 40.8% (37% plus 3.8%). As stated earlier and as will be addressed later in the outline, the distribution of income from trusts and estates will in many circumstances provide significant tax savings as between the trust or estate on the one hand and the beneficiaries on the other.

Income Tax Considerations Take Over – Basic Estate Planning Requires Retooling

As denoted above, the income tax rates – without regard to any State income taxes – are effectively equal to 37% for taxpayers in the maximum tax bracket, plus additional amounts imposed by the NII. By contrast, the estate, gift and generation skipping transfer tax rate is equal to 40% with no additions. Furthermore, transfer taxes are imposed only on such amounts which are in excess of statutory limits of $10,000,000 indexed for inflation, scheduled by statute to be reduced to the $5,000,000 indexed limitation incorporated in the Code prior to 2018. Stated another way, the $10.000,000 limitation is temporary – it remains until December 31, 2025 when it decreases to $5,000,000 (both amounts indexed for inflation).

The inflation index has a baseline of the year 2010. The exemption amount in 2023 is in an amount equal to $12,920,000. Accordingly, any taxpayer with transfers during life or upon death which are cumulatively less than $12,920,000 will not be subject to the federal transfer tax. Said limit as noted increases every year via the above referenced inflation index. While inflation for future years cannot be presently determined, the index from 2022 to 2023 caused an increase in an amount equal to $860,000. If inflation continues at approximately the same rate – no guarantees – the exemption amount will be in excess of $7,000,000 <u>after</u> the reduction in the exemption amount occurs on January 1, 2026.

Married couples effectively can exempt twice the amount as a single individual. Since the advent of Portability – a subject outside the scope of this outline – the ability to utilize both exemptions has become easier. Accordingly, married couples can transfer assets in an amount equal to $25,840,000 - even if there were no future inflation – without the incurrence of a federal transfer tax. Once the exemption decreases and with the utilization of the projected inflation rate delineated above, the amount will equal approximately $14,200,000.

<u>Note</u> – If a spouse dies and does not utilize all or a portion of the exemption – statutorily entitled the Basic Exclusion Amount ("BEA") - the application of Portability will enable the surviving spouse to obtain the unused exemption – statutorily entitled the Deceased Spouse Unused Exemption ("DSUE") – pursuant

to rules outside the scope of this outline. The DSUE is not indexed for inflation; only the BEA of the surviving spouse is further indexed for inflation.

Planning for Basis

To the extent that an individual dies in possession of appreciated assets or said assets are otherwise included in the gross estate of a decedent, any such appreciation generally avoids income taxation pursuant to Section 1014 of the Code. Such avoidance is commonly referred to as “step-up in basis” (although it will be applied adversely if the value of the asset is less than the basis). Section 1014 applies whether or not a transfer tax is paid. Therefore, if an individual dies with appreciated assets but the total assets subject to the estate tax is lower than the then available exemption, the pre-death gain with respect to said assets is forgiven notwithstanding that no federal transfer tax is due.

Example – A dies in 2023 with assets in an amount equal to $8,000,000. A made no taxable gifts during his life. The basis of the assets owned by A immediately prior to the death of A is equal to $100,000. There will be no federal estate tax due with respect to the assets owned by A. Furthermore, the basis of the assets is increased pursuant to Section 1014 is increased from $100,000 to $8,000,000.

Accordingly, there is a substantial income tax benefit with no offsetting federal estate tax with the inclusion of all of the assets of an individual who has assets in an amount less than the available federal exemption. Such a strategy is traditionally counterintuitive to that which was a mainstay of estate planning for decades – utilize techniques which diminish the estate. Said traditional strategy was appropriate in circumstances in which the exemption was lower and transfer tax rates were higher.

As recently as 2001, the federal exemption was in an amount equal to $675,000 and the maximum estate tax rate was equal to 55% (with some very large estates subject to a 60% bracket). In that environment, income tax planning was a secondary consideration to the primary concern of the elimination of assets from the transfer tax system. With the advent of substantial transfer tax exemptions and the increase in income tax rates, consideration of purposeful inclusion of an asset in an estate may provide the most favorable estate plan.

<u>The Use of Trusts in Planning – Geometric Growth for Tax and Non-Tax Reasons</u>

Trusts have become a mainstay in estate planning. The ability to provide creditor protection with respect to the assets transferred in an ever-expanding world of potential liability has caused a geometric increase in the utilization of trusts which if properly drafted insulate the assets from “creditors and predators”

The substantial increase in the transfer tax exemption coupled with the repeal of the New Jersey estate tax has permitted clients to transfer substantial wealth without the imposition of a transfer tax. As noted above, a married couple can transfer over $25,000,000 of assets and avoid estate, gift and generation skipping tax consequences. The ability to render such transfers to a trust with the aforementioned creditor protection provides most clients with an ability to properly shield most or all of their assets.

<u>Example</u> – A and B are married. The Wills of A and B are designed to minimize the estate tax consequences upon the respective deaths of each of them and maximize creditor protection. The Wills provide that upon the first death of A and B, an amount equal to the maximum amount that can pass without the imposition of a federal or state estate tax to a credit shelter trust for the benefit of the surviving spouse and the descendants thereof. The remainder will be devised to the surviving spouse in a trust which qualifies for the estate tax marital deduction.

A and B have assets with a combined value equal to $4,000,000, $2,000,000 of which are in the name of A. The credit shelter trust will be funded with all of the assets of A if A were the first to die. Such drafting will eliminate the imposition of any estate tax upon the first death AND as a result of Portability, any federal exemption which is unused will be received by the surviving spouse and further shield all of the assets from the federal estate tax. Furthermore, the trust is shielded from creditors and predators.

What could go wrong? Take a closer look.

Assume A dies in 2023. The credit shelter trust is funded with an amount equal to $2,000,000. No estate tax is due. The trustee of the credit shelter trust invests in growth stocks in order to maximize the amount that will avoid estate taxation on the death of the surviving spouse, the assets of such trust and to whatever amount it

increases being so exempt. B is supported by the income from the assets in the name of B such that there is no increase or decrease in the assets of B for the remainder of the life of B.

B dies in 2033. The assets in the name of B remain in an amount equal to $2,000,000. The investments in the credit shelter trust have been untouched and performed very well. No dividends or sales occurred and the value of the trust as of the date of death of B has increased to an amount equal $5,000,000, all of which will be exempt from the transfer tax system. The perfect home run (cf. Chris Chambliss and Aaron Boone)!! You cannot have a better scenario – but as the old joke goes, “not so fast, Johnson!!”

The children of A and B inherit the assets and in typical fashion sell all of the assets in the trust immediately after the death of B – perhaps even before the funeral. The basis of the untouched growth stocks is identical to its basis on the date of funding - $2,000,000. The sale now produces a long-term capital gain in an amount equal to $3,000,000 ($5,000,000 less $2,000,000). The income tax rate is approximately 30% (20% long-term capital gain plus 3.8% NII Surtax plus State income tax) and the total income taxes due are equal to $900,000 ($3,000,000 x 30%).

The taxable estate of B is equal to $2,000,000 (ignoring deductions). There is no estate tax Accordingly, the total estate and income tax liability is equal to approximately $900,000 ($900,000 income taxes plus zero estate tax).

Assume instead that A and B created no trusts in their Wills and simply left everything to each other – the classic “I love you” Wills which we have been discouraging for decades. In this event, B receives all of the assets of A upon the death of A. There are no estate taxes due; the entire transfer is eligible for the estate tax marital deduction.

B dies years later with an estate in an amount equal to approximately $7,000,000. There is no federal estate tax; the BEA and the DSUE available to B is greater than $7,000,000. When the children of A and B sell the growth stocks, since all of the assets were included in the estate of B, there is no gain and accordingly no income tax; all of the assets receive a “step up in basis” pursuant to Section 1014 of the Code.

Accordingly, the "I love you" Wills which estate planners have traditionally discouraged produces no income or estate taxes while the traditional estate plan produces a combined tax in an amount equal to $900,000. Stated another way, the traditional plan pursuant to this hypothetical produces a substantially inferior tax result than the plan estate planners have discouraged!!!

It is self-evident that the facts in the above example are not applicable in all circumstances and that the traditional estate plan which includes the utilization of a credit shelter trust may still be a valuable estate planning technique; the non-tax creditor protection and the flexibility of distributions to multiple beneficiaries is worthwhile to most clients. Furthermore, it is more likely than not that a substantial portion of the assets in the credit shelter trust will be bought and sold between the dates of death of the spouses and therefore cause income taxes to be imposed. However, it is equally self-evident that it is imperative that estate planners should (i) draft documents which provide flexibility which will enable the adopted plan to minimize overall taxes and (ii) monitor created trusts on an annual or more frequent basis in order to take advantage of the flexibility.

Drafting Strategies to Provide Appropriate Flexibility – "Basis If You Need It"

The adverse tax consequences in the above example could have been avoided if the document were drafted with sufficient flexibility to permit transactions to occur between the creation of the trust and the death of the surviving spouse. Specifically, if it were apparent that the assets in the trust would produce a superior tax result if distributed to the surviving spouse, the trust should contain provisions which permit same.

Trustee and Co-Trustee Ability to Distribute to Surviving Spouse

The trust accordingly should provide for the discretionary distribution of income and principal to the surviving spouse. If the surviving spouse is not the trustee, the independent trustee can have the right to distribute for any reason, beyond the limits of an ascertainable standard.

If the surviving spouse is the trustee, the ability to distribute to himself or herself must be limited to an ascertainable standard – typically for the health, education, maintenance and support of the surviving spouse. Distributions pursuant to more

liberal standards – for example, the happiness or comfort of the surviving spouse will in all likelihood cause the trust to be included in the estate of the surviving spouse pursuant to Section 2041 of the Code whether or not such result is desired.

Estate planning practitioners may wish to consider the addition of a co-trustee in addition to the surviving spouse as trustee solely for the purpose of the allowance of distributions beyond the ascertainable standard. If an independent trustee and not the surviving spouse possesses such power, there is no risk of automatic inclusion in the estate of the surviving spouse.

If it became evident that it would be more advantageous to have all or a portion of the assets of the trust included in the estate of the surviving spouse, the provision in the trust to allow a third party to make distributions to said surviving spouse without an ascertainable standard restriction would create a mechanism to allow such distributions.

Example – Assume a trust contains assets with a value in an amount equal to $5,000,000, $2,000,000 of which are substantially appreciated assets. Assume further that the inclusion of the appreciated assets in the estate of the surviving spouse will not cause a federal tax to be imposed.

If the right to distribute assets to the surviving spouse is limited by an ascertainable standard, the trustee in all likelihood will not be able to distribute the appreciated securities – and thereby obtain the desired increase in basis and an income tax savings. In the event that the trustee – or independent co-trustee - can distribute without regard to a standard restriction, the distribution can occur and the desired result achieved.

Assume instead that the determination is made that the appreciated assets should remain in trust, perhaps because it is anticipated that said assets will not be sold for decades – if at all – and the lessening of a potential future estate tax outweighs the eventual potential income tax cost with respect to the sale of the appreciated assets in the future. In that event, the trustee need not invoke the right to render such a distribution. Irrespective of the ultimate decision, the flexibility contained in the terms of the trust are necessary to provide the trustee with a choice.

Provide a Third Party with the Authority to Grant the Surviving Spouse a General Power of Appointment

An additional drafting technique which estate planning practitioners may wish to consider is a provision which allows a third party the right to grant the surviving spouse a general power of appointment over the assets of the trust. If it appears that tax circumstances would be better if the assets were included in the estate of the surviving spouse – as in the example above – the third party could then grant the power and cause inclusion in the estate.

Note – the surviving spouse should not be provided with the power directly, nor should he or she have the ability to create the power. In either event, the assets will automatically be included in the estate of the surviving spouse, whether or not same would be the desired result.

Variations with respect to the ability to grant a general power of appointment might be appropriate. For example, the ability to grant the power could be structured such that the general power of appointment is limited in some capacity. For example, the power could be limited to (i) only appreciated assets, (ii) a specific amount – for example, $2,000,000 – or (iii) a specific amount but only with respect to appreciated assets. This "fine tuning" would narrow the assets which are desired to be included in the taxable estate of the surviving spouse – and thereby obtain the appropriate basis adjustment – rather than an "all or nothing" approach which would result from a broad general power of appointment.

Note – The power must be restricted such that the surviving spouse does not have an option to choose the assets over which the power can be applied. The Service contends that if such a power exists, the power applies to all of the assets over which the power could possibly be exercised.

Monitorization - Now a Requirement

Whether or not to distribute assets to a surviving spouse and/or to grant the power of appointment cannot be accomplished without sufficient information available to render the proper decision. Historically, estate planning practitioners drafted trusts and subsequently remained engaged with respect to the funding of said trusts – and then allowed the trustee and financial advisors to manage the trusts. The changes

which render income taxes a driving force - in the above scenario the possible desire to force certain assets to be included in the taxable estate of the surviving spouse – renders necessary the continued involvement by the tax advisor – often the estate planning practitioner – to ensure a proper result.

Perhaps of even more importance, the increase in the income tax rates imposed by TCJA, ATRA and ACA render critical the monitorization of trusts in order to minimize the potential annual impact such taxes may have in the trust and estate arena. The subsequent segment of this outline addresses the concerns and contains certain planning suggestions – submitted for your approval – which practitioners may choose to utilize in order to help minimize said impact.

Income Taxation of Estates and Trusts – A Brave New World

The income tax rates resultant from TCJA, ATRA and ACA have a substantial impact with respect to trusts and estates – in many circumstances more dramatic than that which is applicable to individuals. Specifically as denoted above, the thresholds at which the maximum income tax rates and the NIIT are imposed are substantially lower in connection with trusts and estates than with respect to individuals.

The 37% maximum income tax rates and the NIIT are imposed on trusts and estates with respect to undistributed taxable income in excess of $14,450 for 2023. The increase in the long-term capital gains rate from 15% to 20% occurs at a slightly higher threshold.

The low thresholds applicable to trusts and estates render clear the severity of the potential tax liability that can be incurred. Ordinary investment income in excess of the threshold will be taxed at a federal rate equal to 40.8% (37% plus 3.8%). If the trust or estate is subject to State income taxation, the combined rate could be as high as 50%. Long-term capital gains – pursuant to the assumption that the thresholds are exceeded - will be taxed at a federal rate equal to 23.8% (20% plus 3.8%) and if subject to State income tax at a combined rate equal to approximately 30%. Since most trusts and estates have assets which produce investment income, most trusts and estates will be subject to the above stated rates. Even if a trust or estate had non-

investment, non-passive income, only the NIIT of 3.8% will be eliminated; the remaining rates will apply once the threshold is exceeded.

Note – The rules that follow apply equally to trusts and estates unless otherwise noted. For convenience, the term "trust" will be utilized in lieu of "trusts and estates".

Undistributed Taxable Income

While the thresholds to impose the tax rates described above are low, the taxes are only imposed upon the trust to the extent that the trust has undistributed taxable income ("UTI"). Accordingly, if all of the income is distributed to the beneficiaries, none of the income is taxable to the trust; basic income tax law principles transfer taxable income from a trust to the beneficiaries pursuant to a series or rules contained in Subchapter J of the Code. This outline will not delineate those rules – there are textbooks and treatises which address same in detail. However, this outline will highlight those elements which are of critical import in connection with the planning which may be utilized by practitioners in order to minimize the overall impact of the current income tax laws.

Generally, income is taxed to a trust to the extent of UTI. Distributions to beneficiaries to the extent that such distributions are included and considered part of Distributable Net Income ("DNI") – addressed below – transfer the taxable income from the trust to the recipient beneficiaries, generally in proportion to the character of income transferred.

The Code renders clear that any distribution included in DNI will transfer the taxable income from the trust or estate to the beneficiary; it matters not that the trustee delineates the distribution as principal. The first dollars distributed – as long as the distribution is considered from DNI - irrespective of classification are deemed to transfer the taxable income from the trust to the beneficiaries.

Note – The interrelationship between DNI and taxable income and the manner in which each affects the amount of taxable income that will be distributed to the beneficiaries is addressed below. For purposes of the portions of this outline preceding that topic, assume that all distributions are derived from taxable income which is included in DNI and the taxable income accordingly transferred to the

beneficiaries to the extent of the distribution as otherwise noted. Stated another way, the examples below assume that every dollar distributed to beneficiaries transfers taxable income from the trust to the beneficiaries unless otherwise noted.

Examples – Assume Trust A has taxable income in an amount equal to $50,000 which comprises $10,000 of interest and $40,000 of qualified dividend income. The trustee makes no distributions of same. The entire taxable income in the amount of $50,000 is taxed to the trust; the trust pays the tax at the effective rate for each type of income earned.

Assume instead that the Trustee distributes an amount equal to $30,000 to the beneficiaries. Irrespective of the classification by the trustee of the distribution –e.g., income or principal - the beneficiaries will be taxed in connection with $30,000 of income proportioned between - in this example - two classes of income. Accordingly, the beneficiaries will report interest income in an amount equal to $6,000 ($30,000 total distribution treated as taxable income multiplied by $10,000/$50,000 or 20% - the ratio of interest income of the trust to total taxable income of the trust and qualified dividend income in an amount equal to $24,000. ($30,000 x $40,000/$50,000 or 80%).

Assume instead that the Trustee distributes an amount equal to $50,000 to the beneficiaries. Irrespective of the classification by the trustee, all of the taxable income will be reported by the beneficiaries in proportion to the income earned – in this example $10,000 of interest income and $40,000 of qualified dividend income. There is no UTI taxed at the trust level.

Finally, assume that the Trustee distributes an amount equal to $100,000 to the beneficiaries. The amount of taxable income reported by the beneficiaries with respect to such distribution cannot exceed the amount of taxable income earned by the trust. Accordingly, the income reported by the beneficiaries is limited to an amount equal to $50,000 – in the same proportions denoted above - notwithstanding that the beneficiaries have received in excess of said amount. The excess is treated as a non-taxable distribution of principal.

Note – The proportionate rule delineated above does not apply if the trust instrument itself dictates that specific classes of income are to be distributed to different beneficiaries. For example, if the trust provides that any interest income distributed

shall be paid to A and any dividend income shall be distributed to B, then A will report the interest income distributed and B will report the dividend income distributed.

<u>Example</u> - The trust contains the above distribution requirements and has $50,000 of taxable income, $10,000 of which is interest income and $40,000 of which is dividend income. The trustee distributes amounts equal to $8,000 to A and $22,000 to B. A will recognize interest income in an amount equal to $8,000 and B will recognize dividend income in an amount equal to $22,000. The UTI is in an amount equal to $20,000 ($50,000 less $8,000 less $22,000). The trust will accordingly recognize taxable income of $20,000, $2,000 of which is recognized as interest income ($10,000 less $8,000) and $18,000 of which is dividend income ($40,000 less $22,000).

<u>Note</u> – The proportionality rule cannot be adjusted with the insertion of language in the trust instrument which merely states that taxable income will be allocated to certain beneficiaries. The adjustment is viable only in the event that the trust instrument provides that the actual distributions relate to a particular class of income – as per the above example.

<u>The Exceptions (There always are)</u>

As denoted in detail below, monitoring and planning in an effort to minimize income tax liability will oftentimes relate to the transference of taxable income from the trust to the beneficiaries via distributions to the beneficiaries. However, there are certain instances in which distributions will either not provide the desired effect or be limited in such effect. These exceptions are as follows:

<u>Grantor Trusts</u> – Grantor Trusts are trusts which contain certain provisions the result of which renders the grantor of the trust responsible for the income, deductions and credits, not the trust or its beneficiaries. The provisions which cause a trust to be treated as a Grantor Trust are outside the scope of this outline. Distributions from Grantor Trusts will not shift the responsibility for taxable income; the income for the trust is taxed to the grantor irrespective of the distributions.

Simple Trusts – Simple Trusts are trusts which require all of the fiduciary income to be distributed to the beneficiaries at least annually. As a result, planning to distribute ordinary income is effectively not an available planning technique; the distributions are required and accordingly taxed to the beneficiaries, whether or not the result is desired. Capital gain income – both long-term and short-term – poses different tax challenges as more particularly addressed below.

Electing Small Business Trusts – Shares of stock in corporations which elect to be taxed pursuant to the provisions of Subchapter S of the Code – commonly known as Subchapter S Corporations – have restrictions with respect to ownership. Trusts may own Subchapter S Stock, but only if they are (i) grantor trusts, (ii) qualified Subchapter S Trusts – QSSTs - which have special requirements outside the scope of this outline, (iii) for a limited period of time, certain testamentary trusts or (iv) trusts which do not fall within one of the abovementioned categories and elect to be eligible for Subchapter S ownership status; such trusts are known as Electing Small Business Trusts – ESBTs.

An ESBT, like any other Subchapter S stock shareholder, is taxed on its proportionate share of taxable income earned by the Corporation. However, distributions from ESBTs to the extent that they reflect the income earned by the Subchapter S Corporation do not transfer said taxable income from the trust to the beneficiaries. An ESBT is taxed on such income – at the maximum tax rate – notwithstanding distributions. Accordingly, planning to minimize income tax liability via a distribution of Subchapter S income from an ESBT will not accomplish the desired result.

Distribution Planning To Minimize Income Tax Liability

Distributions from trusts to beneficiaries can be an effective mechanism to reduce overall tax liability. As stated above, trusts will be taxed with respect to UTI in excess of thresholds much lower than the thresholds applicable to beneficiaries. Unless the beneficiary has income which renders him or her in the highest income tax bracket, a distribution in most instances will produce an overall income tax benefit.

Example – Trust A has taxable income in 2023 in an amount equal to $50,000, all of which is interest income. B is the discretionary beneficiary and has adjusted gross income in an amount equal to $100,000. Both A and B are subject to New Jersey income taxation.

If no distributions are made from the Trust, income tax at a rate equal to nearly 50% (37% plus 3.8% plus New Jersey) will be paid with respect to the taxable income in excess of $14,450. If the trustee distributes $50,000 to B, the trust pays no income tax – there is no UTI – and B recognizes the interest income.

Assume B is in the 33% combined federal and State tax bracket after the inclusion of the income recognized from the Trust. The increase in adjusted gross income from $100,000 to $150,000 will not trigger the NIIT; B is under the threshold in connection therewith. Accordingly, there is nearly a 17% tax rate shift with respect to the distribution.

Careful analysis of the tax ramifications at the State level must be considered. The distribution from a trust not subject to State income tax to a beneficiary subject to state income tax may offset some or all of the benefit attributable to the distribution. By contrast, the reverse scenario may enhance the benefit.

Distributions have other tax effects on beneficiaries and must be considered. The increase in adjusted gross income and taxable income can cause social security benefits to be taxable, limit or eliminate current deductions related to passive real estate investments and similarly limit the use of other credits or deductions. Careful analysis of these effects must be considered.

Distributions Directly to Third Party Creditors and the Use of Entities – The Best of Both Worlds?

While trust distributions may produce income tax savings, there are numerous non-tax reasons to deprive a beneficiary of a distribution. Many times, the very existence of the trust is the prevention of assets directly in the possession of the beneficiary.

In the event the beneficiary is adult, mature, responsible, credit risk-free and marital risk-free, a distribution may be warranted. To quote Chris Berman – "this just in" – not all beneficiaries can be characterized as such. Tax benefits are terrific, but not

at the expense of a 100% tax when the beneficiary uses the distribution to support a drug or gambling habit.

Suppose however distributions which create overall tax savings could be effectuated without the direct possession of the distribution by the beneficiary. Two planning techniques which practitioners may wish to consider are the following:

Direct Third Party Distributions

If the terms of the trust authorize distributions to or for the benefit of a beneficiary – and practitioners should give serious consideration to drafting trusts which provide precisely that provision – then a distribution can be made on behalf of the beneficiary directly to a creditor to whom the beneficiary has an obligation.

Example – Assume that Trust X provides that the trustee can distribute assets to or for the benefit of Beneficiary A. The trustee desires to distribute monies to Beneficiary A in order to lessen the overall tax liability between the trust and the beneficiary. However, A has a gambling problem and would in all likelihood squander the monies in Atlantic City (or bet it on a Jets-Giants parlay, a sure-fire loser).

A could distribute the monies for the benefit of A by a direct payment to the landlord of A in order to satisfy a monthly rent obligation. Such a payment would be deemed for tax purposes a distribution to A, thereby satisfying the tax objectives, while simultaneously preventing the monies from being squandered. The trustee if desired could add additional third party creditors – car lease payments, utility bills, etc. – if needed to increase the distributions without the risk of the monies being squandered.

The distribution as noted will likely cause an increase in tax liability to the beneficiary, who in turn might be reluctant – or unable – to pay the extra tax due. In that event, the trustee may wish to consider the payment of the extra tax liability for the beneficiary – which itself would be deemed an additional distribution subject to tax and produce a circular calculation – commonly known as a “gross up”. Once the trustee determines the amount of extra tax due via the “gross up”, the payment could be made directly to the taxing authorities. Said payment would be treated for tax purposes in a manner identical to a direct payment to the beneficiary.

Note – Oftentimes trusts are designed precisely for the above noted non-tax purpose; a beneficiary regularly requires monies to be distributed for his or her benefit. In this event, trustees and practitioners must take into consideration the tax ramifications of such distributions.

Use of Entities

There are certain circumstances in which it is either impractical or insufficient to distribute monies to third party creditors and achieve the desired tax result. For example, the trust may have $100,000 of UTI and the beneficiary has few or no third party creditors. In this event – caveat emptor – consider the following:

The trust forms a limited liability company of which it is the sole owner. The trustee subsequently transfers a portion of the assets of the trust to the limited liability company ("LLC"). Thus far, the trust has done nothing of any tax effect – it simply transferred some of its assets to an entity which is disregarded for tax purposes.

Next, the trust transfers a minority interest in the LLC to the beneficiary. Such distribution will transfer taxable income to the beneficiary. However, the beneficiary has no access to the underlying assets within the LLC. Rather, the beneficiary merely possesses a minority interest in an entity over which he or she has no control – a concept not materially dissimilar to transfer tax planning techniques in which clients not willing to gift assets directly to children and grandchildren will instead transfer minority interests in entities to accomplish the intended goal.

Certain rules – and hurdles – need be cleared in connection with the above plan.

First, the amount of the distribution for tax purposes is more complex than distributions of cash. Generally, the amount deemed distributed for tax purposes when an entity interest is distributed is limited to the basis of the interest transferred.

Second, there is a valuation question which may exist with respect to a minority interest in an entity, which affects the amount distributed to the beneficiary.

Third, if and when the trustee ultimately desires to distribute assets from the LLC, it may be necessary to distribute a proportionate share of those assets to the beneficiary – or risk an action for a breach of fiduciary duty. By utilizing only a portion of the

assets of the trust to fund the LLC, a distribution from the LLC is less likely; there should be sufficient assets to effectuate distributions from the trust which are not then owned by the LLC.

Fourth, the distribution as with third party creditor distributions will likely cause an increase in tax liability to the beneficiary, who in turn might be reluctant – or unable – to pay the extra tax due. In that event, the trustee may wish to employ the "gross up" strategy delineated above.

Note – The LLC created by the trustee could contain both voting and non-voting interests, after which the interests transferred to the beneficiary are non-voting interests if for any reason the trustee were concerned with voting rights attributable to LLC members being vested in the beneficiary. Such an arrangement may prove beneficial if a series of distributions of those LLC interests would place a beneficiary – or multiple beneficiaries – in the position to utilize voting rights to usurp the control desired by the trustee.

The Amount of the Distribution – Section 663(b) to the Rescue

If the trustee determines that a distribution is appropriate – either via a direct payment, payment to a third party creditor or via the entity – the determination of the amount of the distribution is necessary. Such determination is not always readily determinable during the tax year. Oftentimes, tax information which determines taxable income to the trust and the beneficiaries for the applicable year in question is not available on the last day of the taxable year – December 31 for almost all trusts.

The issue of the amount to be distributed absent the information necessary to render the determination places the trustee in a compromised position. The cure for the dilemma – at least in part - lies in Section 663(b) of the Code. Pursuant to Section 663(b), if the trustee makes a distribution within 65 days after the end of the tax year – March 6 in a non-leap year of a calendar year taxpayer for the mathematically challenged – the trustee may elect to treat all or any part of the distribution as if it occurred in the prior taxable year (Emphasis Added).

Such a distribution provides terrific flexibility to the trustee in an attempt to determine the amount of the desired distribution. If the trustee is able to obtain sufficient information within the 65 day period to render the decision, the distribution can be made and treated as if it occurred in the prior year.

Even if the trustee does not have all of the adequate information, a reasonable estimate can be made and upon the obtainment of the necessary information at a late date, a final determination can be made. Importantly, the distribution must be made within 65 days after the end of the taxable year, but the election is made on the income tax return ("Form 1041"), which is not due until April 15 and for which an automatic extension can be obtained which will extend the timely filed deadline to September 30. That should be more than sufficient time for the trustee to determine how much of the estimated distribution made in the 65 day period should be allocated to the prior year.

Example - Trust A is a calendar year taxpayer. The trustee does not have sufficient information prior to December 31 to determine the taxable income of the trust or its beneficiaries and thereby determine how much to distribute from the trust to the beneficiaries.

Prior to March 6, the trustee has a better grasp of the amount which should be distributed. The trustee determines that a distribution in an amount equal to $50,000 is a reasonable estimate of the ultimately desired result.

The trustee files an extension to file Form 1041. Prior to September 30, the trustee determines that the treatment of the entire distribution during the 65 day period is best allocated to the prior year. The trustee so elects on Form 1041 and timely files said form.

Alternatively, the trustee ascertains prior to September 30 that it is most tax efficient to treat as taxable income to the beneficiaries an amount equal to $30,000. The trustee now elects on Form 1041 to treat only $30,000 of the $50,000 distribution as applicable to the prior year. The portion of the distribution not so applied in the amount of $20,000 is deemed a distribution for the year in which the distribution actually occurred.

<u>Note</u> – Both (i) estates and (ii) trusts which elect to be treated as part of an estate in accordance with Section 645 of the Code may elect to have fiscal years. The 65 day rule applies to estates and such trusts. If a fiscal year is elected, the 65 days commences on the first day following the end of the fiscal year.

<u>Example</u> - An estate has a fiscal year ended September 30, 2023. The 65-day period commences on October 1, 2023 and ends on December 4, 2023.

The utilization of the 65 day rule has become a key planning technique and has become part of the regular practice of the author. The ability to make a distribution in which the trustee has a choice to apply some or all of the amount of said distribution between tax years provides great flexibility. The author has made part of his practice annual meetings with trustees and relevant professionals in order to plan for distributions within the 65 day period. Not before – that is automatically applied to the then current year; not beyond, that is automatically applied to the subsequent year.

<u>Distributable Net Income and Fiduciary Accounting Income – Here Come The Tax Traps</u>

The ability to distribute taxable income to the beneficiaries is not simply a function of matching taxable income with the distribution. There are limitations with respect to the taxable income which can be distributed. Specifically – and in dangerously general terms, the specifics of which are reserved for the treatises and textbooks – taxable income is distributed out only to the extent of the lesser of (i) the amount of the distribution or (ii) Distributable Net Income ("DNI").

DNI in equally dangerous general terms is equal to the lesser of (i) taxable income (with some adjustments, e.g., without regard to recognized capital losses in excess of capital gains – which have a limit in an amount equal to $3,000) or (ii) Fiduciary Accounting Income.

Fiduciary Accounting Income ("FAI") is the amount of income for state law purposes – not tax purposes – which is treated as income rather than principal. This amount may be substantially different than taxable income.

Putting the terminology together, the amount of taxable income that can be distributed to the beneficiaries is the lower of three amounts – the taxable income,

the FAI or the amount of the distribution. Therefore, if FAI is less than taxable income, some of the taxable income cannot be distributed to the beneficiaries. The portion that cannot be so distributed is "trapped" in the trust and must remain in the taxable income of the trust regardless of the amount of the distribution.

Example – Trust A has taxable income in 2023 in an amount equal to $100,000 and FAI equal to $20,000. The trustee distributes an amount equal to $100,000 to the beneficiaries, perhaps under the belief that the taxable income and the FAI are identical.

The amount of taxable income which can be distributed is the lowest of the three amounts, the FAI in the amount of $20,000. The remaining taxable income in the amount of $80,000 ($100,000 less $20,000) is "trapped" in the trust. The trust accordingly pays tax with respect to taxable income in the amount of $80,000, all of which in excess of $14,450 is subject to the maximum tax rates.

Fortunately, most forms of income are classified as both FAI and taxable income. Other forms of taxable income which are effectively principal – a lump sum distribution from an IRA for example – can at least in part be converted from principal to FAI pursuant to various state law equitable adjustment laws.

However, some forms of taxable income cannot be converted to FAI at all. The most common – and effectively problematic – is taxable income allocated to the trust by an entity of which it has an ownership interest and from which there are no distributions to the trust.

Example – Trust A owns a 40% interest in X LLC, which similar to most LLCs is taxed as a partnership. X LLC has taxable income in an amount equal to $500,000 and makes no distributions to its owners during 2023.

Trust A accordingly has taxable income attributable to X LLC in an amount equal to $200,000 (40% x $500,000) and receives a K-1 which reflects same. There is no FAI with respect to X LLC; Trust A received no distributions from X LLC which could count toward FAI.

Assume that all of the other taxable income of Trust A in an amount equal to $30,000 is FAI. Irrespective of the amount of the distribution by the Trust to the beneficiaries, the taxable income that can be transferred to the beneficiaries is limited to $30,000,

the amount of the FAI. The taxable income attributable to X LLC is "trapped" in the trust.

The Cure – If One is Available

If an entity actually distributes some or all of the taxable income to the equity owner – in this case, the trust – such distributions are generally treated as part of FAI. Therefore, if the Trust actually receives distributions in the amount of the taxable income, the FAI and the taxable income will be equal and any distributions up to that amount will now pass taxable income to the beneficiaries.

Example – Assume the same facts as in the above example, except that X LLC distributes an amount equal to $200,000 to Trust A and the trustee correctly treats the distribution as FAI. The Trustee distributes – pursuant to the 65 day rule or otherwise – an amount equal to $225,000 to the beneficiaries.

The amount of taxable income that can be distributed is the lowest of FAI, taxable income or the distribution. In this example, all of the taxable income in an amount equal to $230,000 ($200,000 from X LLC and $30,000 from other taxable income) is also FAI. The amount of taxable income distributed is equal to $225,000, the lowest of the three amounts. Therefore, taxable income is transferred to the beneficiaries in an amount equal to $225,000; the remaining $5,000 ($230,000 less $225,000) is the UTI taxable to Trust A.

Oftentimes, the trust and the entities in which the trust is an equity owner are related. In that event, it is incumbent upon the practitioner to plan for necessary distributions from the entity to the trust if the desired result is to have sufficient FAI to in turn enable distributions from the trust to transfer taxable income to the beneficiaries. Alternatively, the trustee or professional may need to contact the appropriate representative of the entity and attempt to procure a necessary distribution.

Some entities have agreements which require minimum distributions to its owners. To the extent that an investment is being made prospectively, perhaps the requirement of a minimum distribution should be negotiated as part of the agreement between or among the parties.

Warning - There is no 65 day rule with respect to distributions from entities to its equity owners, trusts or otherwise. Accordingly, if it is desired to render a

distribution from an entity to a trust in order to increase FAI, said distribution must be made such that it is included in the FAI of the trust for the desired year. If we assume that the entity and the trust both are calendar year taxpayers – an assumption that will be true most times – the distribution from the entity to the trust must occur by December 31. This requires practitioners to be actively involved at the end of the calendar year in order to ensure that the distribution is timely completed – as if estate and tax practitioners do not have enough already at the end of each year!!

Note – Although the distribution from the entity to the trust must be made by the end of the year in order to appropriately increase FAI, the trust can avail itself of the 65 day rule with respect to the distribution from the trust to the beneficiaries.

Capital Gains – The Distribution Maze

Trusts commonly have capital gains – both long-term and short-term – as a portion of taxable income. As stated above, long-term capital gains will be subject to federal income tax rates at 23.8% in the event that UTI is over the thresholds; short –term capital gains rates in such circumstances are taxed at 40.8% -- plus State income tax in each event where applicable. If we assume that the trust is subject to New Jersey income tax, the rates respectively are approximately 30% and nearly 50%. Accordingly, planning with respect to distributions to beneficiaries from trusts which have capital gains can produce significant tax savings.

However, capital gains while included in taxable income are not ordinarily included in DNI. Intuitively, this is logical. Capital assets are considered principal and gains and losses with respect to the exchange of said assets – as opposed to ordinary returns thereon – are considered principal. The distinction between principal and income is the springboard by which capital gains are not ordinarily included in DNI. This could – without the relief provisions addressed below - produce a trap for the unwary client and practitioner in a manner not materially dissimilar than circumstances in which the trust has taxable income but insufficient FAI to permit an appropriate transfer of taxable income to the beneficiaries.

Example – Trust A earns taxable income in an amount equal to 50,000, all of which is short-term capital gain. The trustee distributes $50,000 to the beneficiaries in an effort to transfer the taxable income from the trust to the beneficiaries. Without the

relief provisions addressed below, the short-term capital gain is not included in DNI, the distribution does not transfer the taxable income to the beneficiaries and Trust A remains liable with respect to the taxable income in the amount of $50,000.

Accordingly, it is necessary to have capital gains included in DNI in order to transfer the taxable income related thereto resultant from a distribution to a beneficiary. The default rule is as denoted above – capital gains are not so included.

Fortunately, the Regulations provide three alternative mechanisms by which capital gains can be included in DNI and thereby allow for the desired result. Regulation 1.643(a)-3 delineates the alternatives, provides preliminary language with respect to the use thereof and denotes fourteen (14) examples of the application of the alternatives.

Preliminarily, the alternatives are available only if (i) they are permitted pursuant to the document and local law or (ii) applied pursuant to a reasonable and impartial exercise of discretion by the fiduciary in accordance with local law or the governing instrument. It would accordingly appear that a fiduciary with broad powers acting reasonably and impartially should be able to satisfy the preliminary test.

The three alternatives are contained in Regulation 1.643-3(b)(1),(2) and (3). The author entitles them (i) the Automatic Allocation Rule, (ii) the Consistency Rule and (iii) the Utilization Rule (No Patent Pending). Each is examined below.

The Automatic Allocation Rule – Pursuant to the Automatic Allocation Rule, capital gains will be included in DNI if they are allocated to income in accordance with the governing instrument or pursuant to State law. Most State laws do not assign capital gains to income, except for that portion of a unitrust which exceeds ordinary income, in which event that portion of the capital gain converted to income via the unitrust election will be included in DNI.

Example – A trust with assets in an amount equal to $1,000,000 provides that all of the income shall be distributed to A and defines income in a unitrust format – 4% of the value of the trust is considered income in lieu of the actual income earned. The trust earns ordinary income in an amount equal to $25,000 and capital gain in an amount equal to $30,000.

Without the Automatic Allocation Rule, only the ordinary income in an amount equal to $25,000 would be included in DNI and the distribution to the beneficiary would transfer only $25,000 of taxable income; the remaining taxable income of $30,000 would remain as taxed to the trust.

However, the trust provides that an amount equal to 4% of the value – in this event, $40,000 – shall be distributed to the beneficiary and considered to be treated as income. The Automatic Allocation Rule treats that portion of the capital gain as included in DNI to the extent of the amount necessary to equal the unitrust income - $40,000 in this example. Accordingly, $15,000 ($40,000 unitrust amount less $25,000 ordinary income already included in DNI) will be included in DNI and transferred to the beneficiary – along with the ordinary income equal to $25,000.

The unitrust is a somewhat limited application – although perhaps the most common and therefore highlighted – of the Automatic Allocation Rule. Another method to obtain the result is to state in the trust document itself that all capital gains are allocated to income. In this event, all capital gains will be included in DNI and the taxable income attributable thereto transferred to the beneficiaries upon a distribution.

At first blush, it would appear a perfect solution. Perhaps we should draft our trusts – or decant the assets to a new trust – which contain such a provision. In this event, it will ensure the transferability of taxable income to the beneficiaries. Two points of caution:

First, if the trust is designed such that the income beneficiaries and remainder beneficiaries have disparate interests, such a provision could create unfairly favorable treatment in favor of an income beneficiary to the detriment of a remainder beneficiary.

Example - A creates a trust with income for life to second spouse without principal distributions, remainder to children by a first marriage. The purpose of the trust is to provide ordinary income to the second spouse for the remainder of his or her life, with the children as the ultimate beneficiary of the principal.

If the trust contains a provision which allocates capital gains to income, the intent to provide the children with principal upon the death of the second spouse may be

destroyed. Assume the trust has as its sole asset stock with a fair market value in an amount equal to $2,000,000 and a basis equal to $100,000. If the trustee sells the asset, a capital gain will be recognized and the provision will treat such capital gain as income and distribute an amount equal to $1,900,000 to the second spouse, leaving only $100,000 as the remainder for the children in clear violation of the intent of A.

By contrast, consideration of the inclusion of the provision might be appropriate – with the caveats noted below - with respect to a trust which is purely discretionary in nature and with respect to which there is no concern if the present beneficiaries are favored at the expense of the remainder beneficiaries.

Example – A creates a wholly discretionary trust for the benefit of child C for the remainder of the life of C. Upon the death of C, any remainder will be devised to the children of C. If the primary concern of A is the welfare of C and is ambivalent as to the remainder interest, such a provision would not thwart the intent of A. In this event, all capital gains will be included in DNI pursuant to the Automatic Allocation Rule and allow for the transfer of such income to C with respect to distributions thereto.

Note / Caveat – In the event that C is in a lower tax bracket than the trust, the distribution may produce a favorable tax result. However, it will also force more assets out of the trust to C than might be desired. Furthermore, it is possible that C could in certain years pay more tax than the trust. Even if both the trust and C are taxed at the maximum federal tax rate – which at first blush may appear to produce a tax neutral position – (i) C may have a higher state income tax rate than the trust and (ii) the inclusion of the taxable income of the trust income by C in his or her adjusted gross income may cause a higher tax via one or more reasons denoted above.

The Consistency Rule

Capital gains may be included in DNI and thereby enable the desired result to occur even if capital gains are allocated to corpus as long as distributions to beneficiaries are consistently treated as distributions which transfer capital gain income on the books, records and tax returns of the trust.

In its basic format, the rule is strikingly simple – a trustee can include capital gains in DNI and transfer the taxable income to the beneficiary as long as the trustee does so each year of the trust. However, certain issues and interpretations of the Consistency Rule unanswered by the Examples in the Regulations require further analysis.

A primary issue which is unanswered is exactly with what does the trustee need be consistent. One interpretation of the Rule would require that all capital gains from any source must be treated consistently. Another interpretation would allow the trustee to be consistent only with respect to classes of assets. For example, it has been argued that the trustee could treat the sale of equities in one manner and the sale of bonds or real estate differently. Drilling further, it has been argued that a trustee could treat the securities on one exchange differently than securities on another exchange – or perhaps IBM stock in one manner and Apple stock differently.

The Regulations and Examples provide no guidance with respect to the degree to which consistency need apply. The author believes that if the differences are so micromanaged that the overall effect is there is no consistency that can be shown, the Consistency Rule will not have been deemed to apply. At a minimum, it would appear that some separate classes need be created and the records and tax returns reflect consistency within each class.

<u>Note</u> – The Consistency Rule does not appear to require that distributions are consistently made – merely that at such time as distributions are made, the treatment is consistent with prior distributions.

<u>Example</u> – The Trustee of Trust A makes a distribution to beneficiaries in Years 1 and 2 and applies capital gains to DNI either in total or by a representative class and thereby transfers capital gain income to the beneficiaries. In Year 3, the Trustee makes no distributions. The Trustee has not violated the Consistency Rule. There are no distributions in Year 3 with which to be consistent relative to the distributions in Year 1 and 2.

<u>The Utilization Rule</u>

The Utilization Rule was added to the Regulations in 2004 and has created a more flexible opportunity to include capital gains in DNI. A critical facet of the Utilization Rule – there is no year-to-year consistent treatment requirement as per the Consistency Rule.

An examination of the language of the Utilization Rule provides its general understanding. Capital gains can be applied to corpus and still be included in DNI and thereby transfer capital gain income to beneficiaries via distributions if the gains are "actually distributed to the beneficiaries OR utilized by the fiduciary in determining the amount that is distributed.............."

The provision is written in the disjunctive, which means that either of the two prongs enunciated must be met in order to include capital gain in DNI. The first prong requires that the capital gain actually be distributed to the beneficiaries. Therefore, the mere recognition of capital gain by the trust followed by the distribution <u>of that amount</u> to the beneficiary would appear to satisfy the first prong of Utilization Rule.

<u>Example</u> – Trust A, a wholly discretionary trust recognizes capital gain in an amount equal to $60,000. The trustee distributes said amount to the beneficiaries. It would appear that first prong of the Utilization Rule is satisfied.

Assume alternatively that the trust recognized $60,000 of capital gain and $10,000 of interest income and distributes an amount equal to $70,000 to the beneficiaries or alternatively distributes all $60,000 of the capital gain to the beneficiaries and indicates in its books and records that the distribution is entirely derived from capital gain. Irrespective of the tax treatment of the distribution as between interest and capital gain, it would appear that the first prong of the Utilization Rule would be satisfied.

<u>Note</u> – The taxable income transferred to the beneficiaries in the last portion of the above example would be interest income in an amount equal to $10,000 and capital gain in an amount equal to $50,000, notwithstanding that all of the capital gain would be deemed distributed for accounting purposes and would accordingly satisfy the Utilization Rule.

The second prong of the Utilization Rule is more liberal – and a key planning tool for practitioners. The second prong requires only that the trustee utilize the amount

of capital gain that is earned by the trust in its determination of the amount to be distributed. It is not required that all of the capital gain be distributed.

Example - Trust A recognizes capital gain income in an amount equal to $60,000. Based on such transaction or transactions, the trustee determines that it is appropriate and will distribute $30,000 of said capital gain income to the beneficiaries. It would appear that the second prong of the Utilization Rule has been satisfied.

Note – The author strongly recommends that the trustee document that the capital gains were utilized in the determination of the amount to be distributed and the criteria by which the decision was made.

Accordingly, although the general rule does not include capital gain income – short-term or long-term – in DNI and thereby prohibits the transfer of capital gain income to the beneficiaries via a distribution thereto, the use any of the Automatic Allocation Rule, the Consistency Rule or the Utilization Rule many nonetheless accomplish the result.

Investment Alternatives to Minimize Trust and Estate Income Taxation

Trustees may wish to invest all or a portion of the assets of a trust in order to minimize the impact of the substantial income tax rates applicable to a trust. Municipal Bond Interest exempt from income taxes in accordance with Section 103 may be considered. Securities which do not pay dividends and rely on growth for value will eventually be subject to capital gains, but the income therefrom will be delayed until the actual sale. The investment in an overfunded life insurance policy – a subject outside the scope of this outline but clearly worth examining by those not familiar with its substantial tax advantages – might be considered. Real estate investments the investments in which income and distributions are sheltered by depreciation and other non-cash deductions are also a consideration.

The concept of tax managing a portfolio has also gained in importance. Coordination with an advisor capable of buying and selling securities to offset gains with losses and engage in other tax strategies looms larger, especially for trusts subject to high income tax rates.

Note – An old adage still rings true – the tax tail should not wag the dog. Investment strategies which are designed to enhance return should not be avoided merely to save taxes. On the other hand, tax strategies can be incorporated in an overall investment plan in an attempt to produce the optimal result.

Diversification In a Different Form

General financial prudence dictates that diversification of investments is a main element in the preservation and growth of wealth. It is often recommended that tax advantaged investments – or any investments – should be limited to fall within proper diversification strategies. The author wholeheartedly agrees.

However, in circumstances in which (i) the trust and the individual(s) for whom the trust is established are related and (ii) the trust is much more susceptible to higher income tax rates, the trust can invest heavily in tax advantaged assets without the overall sacrifice of diversification. Rather than the attainment of diversification in the trust and separately by the beneficiary, the trust can invest more heavily in tax advantaged investments while the beneficiary invests in other assets. While neither the trust nor the beneficiary is separately diversified, the trust and beneficiary are collectively diversified.

Example – Trust A and Beneficiary B each has a portfolio equal to $2,000,000. Trust A is subject to maximum income tax rates; Beneficiary B is not. It is recommended that the overall portfolio of $4,000,000 should be invested $500,000 in municipal bonds, $500,000 in growth stocks which do not pay dividends and which it is anticipated will be held long-term, $500,000 in an overfunded life insurance product and $2,500,000 in a classic equity/debt standard allocation portfolio.

Trust A could invest in the municipal bonds ($500,000), the long-term hold growth stocks ($500,000) and the overfunded life insurance ($500,000), along with 20% of the classic equity/debt portfolio. ($2,500,000 x 20% = $500,000). Beneficiary B invests the entire $2,000,000 in the remainder of the classic equity/debt portfolio.

Looked at separately, neither Trust A nor Beneficiary B has a diversified portfolio. Trust A is overly tax leveraged; Beneficiary B is not tax leveraged at all. In the aggregate however, the combined portfolios are properly diversified. The inclusion of all of the tax leveraged investments in the trust will help minimize the tax effect. Beneficiary B will recognize more of the overall taxable income, but such income will be taxed at a rate lower than the rate applicable to Trust A.

Conclusion

The world of estate planning has changed dramatically in light of tax law changes effectuated by TCJA, ATRA and ACA. Income tax considerations are now a driving force with much of the services in which estate planning practitioners engage. Planning to obtain basis of appreciated assets has become a paramount planning opportunity that in most cases cannot be ignored.

The income taxation of trusts and estates has been dramatically affected. Practitioners must not only familiarize themselves with the intricacies of rules which govern trust and estate income taxation, monitoring and annual or more frequent planning has become a necessity. The consequences of improper planning can be severe; the rewards of proper planning in this new hands-on environment provide a great challenge – and a great excitement – for the estate planning practitioner.

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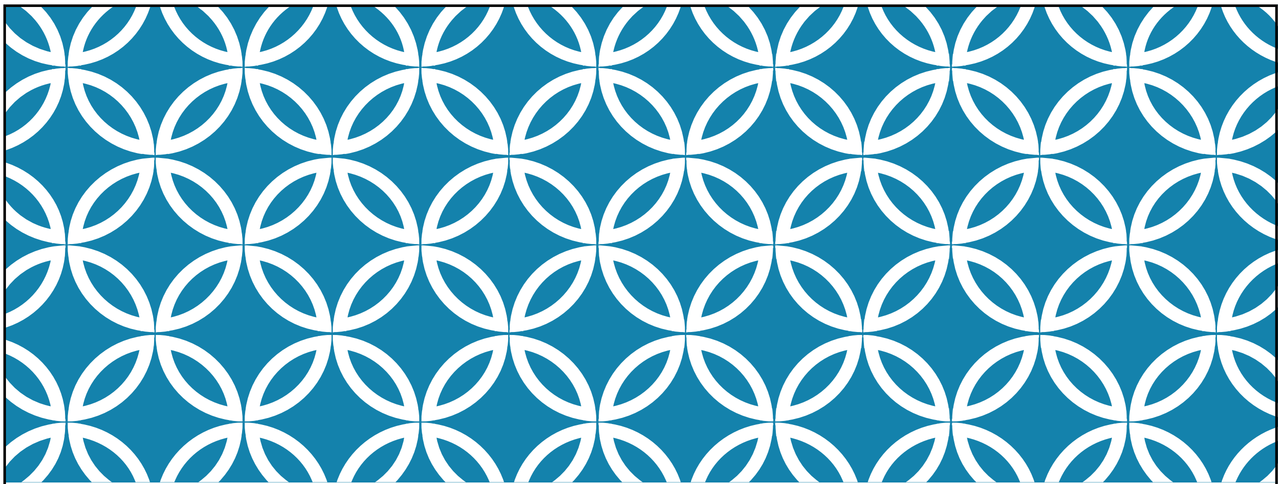


TO TRUSTEE OR NOT TO TRUSTEE?!? THAT IS THE QUESTION…

BY: CRYSTAL WEST EDWARDS, ESQ., CELA

TYPES OF SPECIAL NEEDS TRUSTS

FIRST PARTY SPECIAL NEEDS TRUST

- 42 U.S.C. §1396p(d)(4)(A)
- Established by individual with disabilities or on his or her behalf by a parent, grandparent, guardian or court

THIRD PARTY SPECIAL NEEDS TRUST

- Also known as supplemental benefits trust or supplemental needs trusts
- Established for individual with disabilities with assets of another

POOLED SPECIAL NEEDS TRUST

- U.S.C. 42§1396p(d)(4)(C)
- Separate account for each person managed by non-profit
- Remaining assets in account may be subject to payback or retention

SOLE BENEFIT TRUST

- Transfer of assets from person who needs Medicaid to trust for someone who needs Medicaid
- Payback provision required
- Payments must be on actuarially sound basis

SPECIAL NEEDS TRUST ROLES

Grantor

- The donor of the property that will go into the trust

Trustee

- The one who manages the property and makes distributions

Beneficiary

- The individual with disabilities who benefits from the trust

ACCESS DENIED...

The beneficiary cannot be the trustee

The beneficiary cannot compel distributions

GENERAL TRUST REQUIREMENTS

Supplement, not supplant, government benefits

No true definition of “special need” or “supplemental benefit” … Is less more?

WHAT IS NOT A SPECIAL NEED?

- Basic necessities of life (food, shelter, utilities)
- Incidental spending money (unearned income)
- Gifts
- Insurance on life of disabled beneficiary

FIRST PARTY SPECIAL NEEDS TRUST

- Established with assets of individual with disabilities (as defined in Social Security Act)
- Individual must be under 65 at time of the establishment and funding BUT.... payments irrevocably assigned to SNT (i.e. structured settlement payments) beginning before age 65 and continuing thereafter are acceptable
- Medicaid agency entitled to reimbursement from any assets remaining in trust upon death of beneficiary or trust termination for other reasons
- Reimbursement "dollar for dollar" up to amount paid by Medicaid on behalf of individual

BIG BROTHER?

- If trust is court created or authorized by the court, it may retain oversight in following areas:
  - Accountings
  - Trustee's commissions
  - Investments
  - Limitations on Purchases of Major Assets

LIENS

Medicaid

- Medicaid's right to recovery under Arkansas HHS v. Ahlborn, 2006 U.S. Supreme Court decision is expanded by Section 202 of the Bipartisan Budget Act of 2013

Medicare

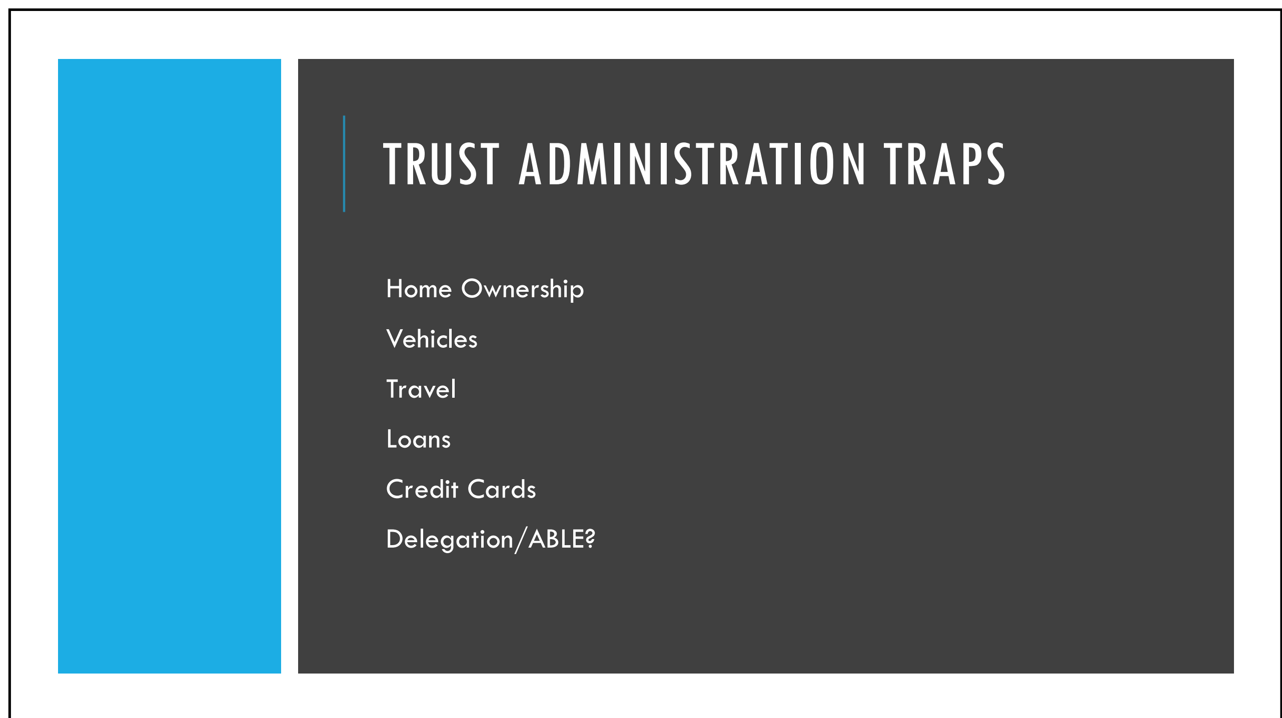
- Medicare, Medicaid, and SCHIP Extension Act of 2007 (MMSEA)
- Medicare Set Aside Trusts and other Arrangements

State Department of Human Services

- ***Beware of any DDD liens!!!!!***

Workers Compensation

ERISA


TRUST ADMINISTRATION TRAPS
Home Ownership
Vehicles
Travel
Loans
Credit Cards
Delegation/ABLE?

HOME OWNERSHIP

Options include:

- Trust owns house, rent is not charged.
- Trust owns house, rent is charged.
- Trust buys house and transfers house to beneficiary
- Trust buys fractional interest in house, such as life estate.

VEHICLES

Purchase of vehicle, maintenance and insurance is permitted

Gas company credit card preferred instead of cash

45-day notice??

TRAVEL

Hotel and restaurant meals may be food and shelter expenses

Must investigate limitations on payments for traveling companions

Foreign travel

- If SSI recipient is out of the country for more than a month, SSI eligibility may be lost until return to U.S.

LOANS

Trust can loan money to beneficiary so long as there is an enforceable agreement

Payback cannot be based on future contingency

Loan must be "feasable" (reasonable expectation that beneficiary can pay back)

If a loan is forgiven it will count as income

If the beneficiary has the loaned money the following month it will count as a resource

School loans are not countable if spent within nine months of receipt on tuition, room and board and other education expenses

CREDIT CARDS

Goods and services purchased with a credit card are not countable as income unless they are “food” or “shelter” and not sold for cash.

Payment by trust to credit card company is not countable as income.

DELEGATION

Trustee may delegate but will still be liable for wrongful or negligent acts of delegates

NJ ABLE?

- What are the benefits to establishing and funding?
- Is the Trustee authorized to fund an ABLE Account?
- Will funding be considered a discharge of fiduciary duty?

CHARACTERISTICS OF A SUCCESSFUL TRUSTEE

- Knowledge of the beneficiary and understanding of his or her needs
- Understanding of the government benefits programs for which the beneficiary participates
- Personal knowledge or access to effective counsel to advise on impact of trust distributions on continued eligibility for benefits
- Thick skin and patience ☺

TRUSTEE APPOINTMENTS

- Family Members
- Corporate
- Non-Profit
- Professional
- Trust Protectors

FAMILY MEMBERS

Advantages	Disadvantages
▪Close familial relationship ▪Understanding of the beneficiary's needs	▪Often challenging to say no ▪Lack of understanding about Medicaid eligibility rules ▪Lack of understanding about intersection between government benefits and trust administration ▪Increased legal fees to obtain proper advice on the funding and management of the trust ▪More complex redetermination or annual accounting process if records are not pristine.

CORPORATE

Advantages	Disadvantages
Better understanding of Medicaid eligibility rules Ability to issue spot Accounting and tax work often handled internally Often maintains better records for annual reporting purposes (including redeterminations)	Often distanced from the beneficiary Increased administration costs to hire care managers May not wish to be adverse to Medicaid agency or challenge unreasonable opinions Increased administration fees including investment fees

NON-PROFIT

Advantages	Disadvantages
Better understanding of Medicaid eligibility rules	Increased administration fees including investment fees
Ability to issue spot	Accounting and tax work may be outsourced
Often maintains better records for annual reporting purposes (including redeterminations)	May not wish to be adverse to Medicaid agency or challenge unreasonable opinions
Social workers on staff to assist with challenging issues or check-in on beneficiary	
Often will accept a trust with much less in assets than a corporate trustee	

PROFESSIONAL

Advantages	Disadvantages
Better understanding of Medicaid eligibility rules Ability to issue spot Often maintains better records for annual reporting purposes (including redeterminations)	Often lacks back-office support to handle a demanding trust beneficiary May outsource tax and accounting work Bifurcated fee system (for example, investment advisor and trust administration duties)

TRUST PROTECTORS

If using a non-family member, it may be advisable to consider a trust protector.

There really is no disadvantage to a trust protector in that the appointment will allow an individual trustee to remove and replace the trustee consistent with the terms chosen by the grantor/settlor

ANY QUESTIONS?
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About the Panelists…

Crystal West Edwards, Certified as an Elder Law Attorney by the ABA-accredited National Elder Law Foundation, is a Principal of Porzio, Bromberg & Newman P.C. in Morristown, New Jersey. She primarily focuses her practice in elder law, special needs planning and advocacy, estate planning and estate administration. She assists seniors, individuals with special needs and their families with complex estate and tax planning, asset preservation, eligibility for means-tested government benefits, fiduciary appointments, and representation and advocacy.

Ms. Edwards is admitted to practice in New Jersey and Pennsylvania, and before the United States District Court for the District of New Jersey and the United States Court of Appeals for Veterans' Claims. She has been a member of the New Jersey State Bar Association Elder and Disability Law Section and the Board of Directors of the National Academy of Elder Law Attorneys (NAELA), and is Past President of the Garden State Bar Association. She is Past President of the New Jersey Chapter of NAELA and has served on the Young Lawyers and Associates Committee of the NJSBA Elder and Disability Law Section.

A former adjunct faculty member at Kean University, Ms. Edwards was honored by the State of New Jersey with a Senate Resolution for "her meritorious history of professional leadership and exemplary dedication." She has lectured statewide on elder law topics and was the recipient of the 2014 Young Lawyer Award from the Garden State Bar Association for her "exceptional commitment to the GSBA, the Community & the Elder and Disability Law Bar."

Ms. Edwards received her B.S., *cum laude*, from the University of North Carolina at Charlotte and her J.D. from Pennsylvania State University's Dickinson School of Law.

Lawrence A. Friedman, Certified as an Elder Law Attorney by the ABA-accredited National Elder Law Foundation, is in private practice in Bridgewater, New Jersey. He concentrates his practice in elder and special needs law; government aid; Wills, trusts, estates and tax law, including the preparation of estate and tax planning documents such as Wills, trusts, powers of attorney and health care directives; nursing home and long-term care planning; guardianships; Medicaid, Medicare and other government programs; special needs trusts to protect disability aid in gift and estate planning; personal injury; divorce settlements; Medicare set-aside arrangements; Division of Developmental Disabilities concerns and other legal matters.

Mr. Friedman is admitted to practice in New Jersey and New York, and before the United States Tax Court. Past Chair of the New Jersey State Bar Association's Elder and Disability Law Section and a member of the Association's Real Property, Trusts & Estates Law Section, he has served as a Director of Somerset ARC (formerly the Association for Retarded Citizens) and has been a member of the New Jersey Chapter of the National Academy of Elder Law Attorneys (NAELA), the Planned Lifetime Assistance Network of New Jersey and the Malaria Foundation.

The author of scores of articles in his areas of expertise, Mr. Friedman is a frequent lecturer for ICLE, the New Jersey State Bar Association and Foundation, NAELA, several elder and disability groups, and other public and private sponsors. He is a recipient of ICLE's Distinguished Service Award, the NJSBA's Distinguished Legislative Service Award for drafting legislation that facilitates the use of special needs trusts and the PLAN/NJ Life Planning Partner Award. Mr. Friedman founded the NJSBA's annual Elder Law Retreat, a two-day educational

symposium for elder law attorneys, and has moderated the ICLE's Sophisticated Elder Law program for 25 years. Copies of his many legal articles and further information on his credentials appear at SpecialNeedsNJ.com, and he also administers the website's frequently-updated blog.

Mr. Friedman received his B.A. from the State University of New York-Binghamton (Harpur College), where he was elected to *Phi Beta Kappa* and served on the University Assembly. He received his J.D. and LL.M. in Taxation from New York University School of Law, where he was Editor of the *N.Y.U. Journal of International Law & Politics* and a Student Fellow of the Center for International Studies. He also received awards from the Association of Trial Lawyers of America Environmental Law Essay Contest and the American Society of International Law Essay Contest.

Mark R. Friedman practices estate planning, elder law and special needs law with Friedman Law in Bridgewater, New Jersey. His work includes creating special needs trusts for disabled clients so litigation proceedings, child support and other payments will not disrupt public benefits; helping seniors plan to prevent long-term care costs from wiping out their savings; and estate planning in first marriages, second marriages and for unmarried clients.

Admitted to practice in New Jersey and New York, Mr. Friedman is Past Chair and former Roundtable Coordinator and Legislative Coordinator of the New Jersey State Bar Association Elder and Disability Law Section. He was Somerset County representative to and Executive Committee member of the NJSBA Young Lawyers, and served on the NJSBA Blue Ribbon Commission on Unmet Legal Needs. Prior to joining the firm Mr. Friedman was a Contributing Editor for The FCPA Blog in Singapore, ROS, where he provided analysis on compliance, corruption and the *Foreign Corrupt Practices Act* (FCPA). He is the author of articles including "Modern Estate Planning for Same-Sex Couples" (*New Jersey Law Journal*, October 14, 2013).

Mr. Friedman received his B.A. from Binghamton University, State University of New York, and his J.D. from New York University Law School, where he was selected as an inaugural Fellow with Fellowships at Auschwitz for the Study of Professional Ethics, which sends law and medical students to Germany and Poland to study their profession's role in the Nazi genocide. He also created the Darfur Victims Project at NYU, leading a team of law students in support of litigation before the International Criminal Court.

Richard H. Greenberg is Senior Partner in Greenberg & Schulman in Woodbridge, New Jersey, where he focuses on tax matters, business and corporate matters, estate planning and estate administration.

Admitted to practice in New Jersey, New York and Georgia, and before the United States Tax Court, Mr. Greenberg is a Fellow of the American College of Trust and Estate Counsel (ACTEC); Past Chair of the New Jersey State Bar Association's Taxation Law and Real Property, Trust and Estate Law Sections; Past Chair of the Association's Corporate Tax Committee; and a member of the Inheritance Tax and Partnership Tax Committees. He is a past President of the Greater Middlesex/Somerset Estate Planning Council, Past Chair of the Essex County Bar Association Tax Committee and a member of the New York State Bar Association Tax, Trusts and Probate Committees and the Middlesex County Bar Association Tax Committee, as well as the Estate Planning Council of Central New Jersey. He is a frequent lecturer and author on numerous estate planning and estate administration topics as well as the

2011 recipient of the Alfred C. Clapp Award bestowed by ICLE.

Mr. Greenberg received his B.B.A. from Case Western Reserve University, his J.D. from St. John's University and his LL.M. in Taxation from New York University.

Shirley Berger Whitenack is a Partner in Schenck, Price, Smith & King, LLP with offices in Florham Park, Paramus and Sparta, New Jersey. Co-Chair of the firm's Elder and Special Needs Law, and Estate and Trust Litigation Practice Groups, she devotes a substantial portion of her practice to elder and special needs law, estate planning and administration, and trust and estate litigation; and is on the New Jersey State roster of approved mediators.

Admitted to practice in New Jersey and before the United States District Court for the District of New Jersey and the Third Circuit Court of Appeals, Ms. Whitenack is a Fellow and Past President of the National Academy of Elder Law Attorneys (NAELA), a member of its Council of Advanced Practitioners (CAP) and Past Chair of the New Jersey State Bar Association Elder and Disability Law Section. A former Trustee of ICLE, she is a member of the Special Needs Alliance and has been a member of the American Bar Association Litigation and Real Property, Trusts & Estates Sections, and the Morris County Bar Association Estates & Trusts and Elder Law Committees. Ms. Whitenack is Past Chair of the Morris County Bar Association's Elder Law Committee and a former Trustee of the New Jersey State Bar Association, for which she has co-chaired its By-Laws Committee. In 2022 she was named a Fellow of the American Bar Foundation.

Ms. Whitenack was an adjunct professor at Stetson University College of Law in its J.D. and LL.M. in Elder Law Programs, and is a frequent author and lecturer for ICLE, NAELA and other professional and charitable organizations. Quoted in publications including the *Wall Street Journal*, *Market Watch*, *Money Magazine* and *Consumer Reports*, she is a contributing author to *New Jersey Elder Law Practice*, 3rd *Ed*. (ICLE), *Trusts for Senior Citizens* (ALI-ABA), *Elder Law Trusts and Estates* (Aspatore) and *Creating a Trust: What You Need to Know* (Aspatore). She is the recipient of numerous honors, including GANJI's Recognition Award in 2003, the NJSBA Legislative Service Award in 2003 and *Amicus Curiae* Award in 2004, ICLE's Distinguished Service Award in 2007, the NJSBA Elder & Disability Law Section's Distinguished Service Award in 2009 and the Community Health Law Project's Ann Klein Advocate Award in 2011. In 2012 Ms. Whitenack was honored by the NJSBA for her long service as a Trustee of ICLE and received the NJSBA's Distinguished Legislative Service Award for her contribution to New Jersey's enactment of the *Uniform Adult Guardianship and Protective Proceedings Jurisdiction Act*. She was the recipient of the Morris County Bar Association's Civil Practice Award in 2015 and in 2017 received ICLE's Alfred C. Clapp Award for Excellence in Continuing Legal Education. She is also the recipient of the 2018 NAELA John J. Regan Writing Award as a co-author of "The Fiduciary Pitfalls of Managing Special Needs Trusts That Own Real Estate" (*NAELA Journal*, Vol. 13, No. 1, Spring 2017) and in 2019 received the prestigious Medal of Honor from the New Jersey State Bar Foundation.

Ms. Whitenack received her B.A., *cum laude*, from the State University of New York at Stony Brook and her law degree, *cum laude*, from Seton Hall University School of Law, where she was Notes & Comments Editor of the *Seton Hall Law Review*.

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Medicaid and Medicare Settlement Considerations
Special Needs Trusts and Medicare Set-aside Trusts

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MEDICAID & SNTs

I. **What Makes a Trust Special?**

A. "Means Tested" if eligibility is based in whole or in part on income and/or resources.

1. As Medicaid and Supplemental Security Income (SSI) limit eligibility based on finances, they are Means Tested.

2. Since Medicare and Social Security Disability Insurance (SSDI) don't base eligibility on finances they are not Means Tested.

B. High earnings may disqualify an individual for disability aid even if it is not Means Tested because an individual who can earn more than threshold amounts is not disabled for purposes of SSDI (and various other kinds of aid).

C. A special/supplemental needs trust (SNT) is a trust that can supplement

Means Tested aid whereas some other kinds of trusts would disqualify a beneficiary for Means Tested aid.

D. At FriedmanLaw, we call a trust funded in whole or in part by the beneficiary a Special Needs Trust and a trust funded entirely by third parties a Supplemental Needs Trust but beware that different lawyers and state laws use their own terminology.

II. Income, Resources and Support

A. Generally, SSI eligibility rules apply when testing eligibility for Medicaid unless federal Medicaid and SSI underlying law differ.

B. SSI treats amounts an individual can access to meet his/her needs for support as income in the earlier of the month received or the month they become available on demand. An amount is a resource if at the start of a month it is available to meet an individual's support needs. Support is food or shelter.

C. Social Security Administration (SSA) considers trust principal countable as a resource for SSI purposes when an individual can

1. Revoke or terminate the trust and then use the funds to meet his/her food or shelter needs,

2. Direct the use of the trust principal for his/her support and maintenance or

3. Sell his/her beneficial interest in the trust.

D. A trust that would not be countable per outline paragraph II.C above will be SSI and Medicaid countable if the trust contains amounts attributable to the beneficiary but does not satisfy additional requirements.

E. Trust income probably will be SSI countable where trust principal is countable although unusual drafting can split the two.

F. SSA generally does not consider a trust that does not contain amounts attributable to a beneficiary to be a resource where individual cannot revoke

or terminate the trust or direct the use of the trust assets for his/ her own support and maintenance.

G. Some income, resources, and rights of an individual's spouse may be treated as if they belonged to the individual when testing the individual's eligibility for Means Tested aid.

H. Where principal of a trust isn't SSI countable to the trust beneficiary, undistributed trust income also isn't SSI countable to the beneficiary.

I. However, even if trust income and principal are not countable, distributions from the SNT may prove disqualifying.
   1. All cash distributions and some in-kind distributions to an SNT beneficiary will count when testing eligibility for Means Tested aid.

   2. Some SNT payments to vendors who provide goods/services to the beneficiary may count when testing eligibility for Means Tested aid.

J. Amounts that may not be legally assigned by law such as Social Security and certain employee benefits are income to the person entitled to an amount even if it is paid directly into trust.

K. A hybrid support/discretionary trust (e.g. "trustees shall distribute for HEMS within the trustees' discretion") is ambiguous. Does it require the trust to fund support or does it leave distributions to trustee discretion?

III. SNTs and Settlements

A. A settlement paid into an SNT that satisfies 42 U.S.C. 1396p(d)(4)(A) or © should not disqualify the SNT beneficiary for most kinds of Means Tested aid.

B. In New Jersey and other states, a personal injury settlement or divorce payment can provide for payments into a qualifying special needs trust (called supplemental needs trust in New York State).

C. It may be more difficult to arrange to pay a worker compensation recovery directly into trust.

D. d4A/C SNTs have statutory protection against disqualification for SSI and Medicaid purposes, but other programs do not have statutory prohibitions against counting an SNT towards Means Tested program eligibility

E. Some Means Tested programs may count SNT distributions that advocates may maintain shouldn't count– e.g. *DeCambre v. Brookline Housing Authority* (D. Mass., 2015) reversed 826 F. 3rd. (1st. Cir. 2016)

F. Of at least equal importance to avoiding disqualification, a special needs trust must be compatible with the beneficiary's individual needs. While a special needs trust must be drafted in a manner that won't disqualify the beneficiary for crucial government aid, the trust must not be so restrictive that it can't buy needed goods and services. For instance, a trust for a person with mental illness may be of little benefit if it can't pay for his housing in the community.

G. Well drafted special needs trust are much more than mere forms drawn primarily to preserve Medicaid eligibility.

1. For instance, form trusts often prohibit a trust from funding support to ensure the trust isn't Medicaid disqualifying. That kind of prohibition isn't necessary and may prevent a huge settlement from meeting a seriously disabled individual's goal to live in a nice condominium.

2. A better approach is to draft a special needs trust to clearly say the trust has no obligation to pay for support but not prohibit desirable expenditures. However, the drafting must be is very tight to ensure the trust isn't obligated to pay for support, which would result in disqualification.

H. Special/supplemental needs trusts also must comply with applicable state requirements.

1. New Jersey Medicaid regulations require special needs trusts to include numerous technical record keeping, reporting, and other requirements.

2. Pennsylvania has tried to limit special needs trust expenditures.

3. New York's Estates, Powers, and Trusts Law's supplemental needs

trusts provisions nearly always should be included in New York supplemental needs trusts but would not be appropriate for a New Jersey trust. Similarly, New Jersey Medicaid regulation requirements shouldn't be included in New York trusts.

IV. Capitation May Make Medicaid Undesirable

A. In NJ and various other states, Medicaid pays managed care organizations a monthly fee whether or not the Medicaid participant receives care in a month.

B. Because d4A/C trusts repay Medicaid when the Medicaid participant dies, it can prove less costly to forego Medicaid and rely on private health insurance in some cases.

C. However, because SSI recipients automatically receive Medicaid in New Jersey and many other states, an individual who does not want Medicaid may have to give up SSI as well.

D. In addition, DDD generally requires participants to maintain Medicaid eligibility whenever possible and particularly when a DDD residential placement is desired.

MEDICARE & MSAs

V. Introduction to Medicare

A. Medicare comes in three flavors– Original Medicare (Parts A and B), Medicare Advantage (Part C), and Medicare Prescription (Part D).

B. Original Medicare Part A covers hospitalization, hospice, rehabilitation, and limited care at home while Part B funds health care services like physician exams and treatments at home or in a facility and equipment. Because Original Medicare includes substantial deductibles, co-payments, and benefit limitations, participants often supplement Original Medicare by buying a private Medigap supplemental insurance policy.

C. Medicare Advantage Part C are private managed care plans that combine Part A and B benefits and possibly more. Medicare Advantage Plans may

be cheaper and/or provide more benefits than Original Medicare but often are subject to gatekeepers and networks.

D. Medicare Part D are private prescription drug plans and can be stand alone policies or bundled with Part C plans.

E. Medicare Part A is free if you or your spouse had at least 40 quarters of Medicare covered employment, you got Social Security Disability Insurance benefits for 24 months, or you have met less common eligibility requirements. If you don't qualify for premium free Medicare Part A, you can buy into Part A for a monthly premium (up to $471 in 2021), which varies based on work history. However, in order to buy into Part A, you also may have to buy Medicare Part B.

F. Parts B, C, and D have premiums.

G. Original Medicare is government administered, single payer health insurance similar to pre-managed care employee health insurance. Original Medicare pays a percentage (sometimes 100%) of allowable costs. As with traditional employee benefit indemnity health insurance, providers may require a patient to pay out of pocket when receiving care leaving it to the patient to file for Medicare benefits.

H. Medicare Advantage Plans typically mirror employer managed care plans and pay full costs (other than co-pays) of allowable care but have networks and may or may not pay toward out of network care costs.

VI. Medicare Secondary Payer Law

A. Medicare Secondary Payer law ("MSP") is section 1862(b) of the Social Security Act.

B. MSP prohibits Medicare paying for health care costs that are obligations of another such as a tortfeasor, no-fault auto coverage, worker compensation plan, or other health insurer.

C. However, where the potentially responsible party refuses to pay (such as before a PI claim settles), Medicare can pay on condition that Medicare must be repaid from any subsequent recovery.

D. Thus, Medicare may cover needed accident related medical care while a PI claim is pending, but Medicare has a claim for repayment against any eventual judgment or settlement.

E. A good argument can be made that Medicare recoveries should be limited to damages that compensate for medicals as opposed to damages for other losses like lost wages. Unfortunately, there is not unequivocal authority for such limits.

F. Self serving allocations between medicals and other kinds of damages do not bind Medicare in any case. Medicare normally respects binding arm's length allocations like jury verdicts and arbitration awards.

G. Medicare can compromise conditional payment claims where a compromise would further Medicare's interests.

VII. Liability to Repay Medicare Conditional Payments

A. The obligation to repay Medicare conditional payments falls on virtually everyone who touches a recovery. Thus, Medicare participants, plaintiff and defense attorneys, health care providers, and insurers all have potential liability to repay Medicare conditional payments.

B. Various U.S. attorneys have sued personal injury attorneys who have disbursed recoveries to clients without first repaying Medicare conditional payments. Medicare has gotten some pretty hefty settlements where PI firms have disbursed settlements without first paying Medicare conditional payments.

C. Personal injury law firms in Philadelphia, Maryland, Texas, and other places have had to spend thousands of dollars of their own money to repay conditional payments that should have been paid from settlements. While some settlements were comparatively small, one was for $250,000 and another for $90,000.

D. Medicare Advantage Plans also have sued lawyers who did not repay their claims before disbursing a PI settlement.

E. Where conditional payments are not paid promptly upon recovery, MSP authorizes Medicare to recover interest and twice the actual conditional payments. In unusual cases, Medicare even can pursue triple damages plus penalties under 31 U.S.C. 3729- 3733. Thus a lawyer who pays plaintiff rather than repaying a conditional payment can be liable for twice the conditional payment, interest, and penalties.

VIII. Medicare Set-aside Trusts ("MSA")

A. MSP also requires participants to protect Medicare's future interests by paying privately (rather than submitting to Medicare) charges for which another is responsible. In other words medical damages should pay for tort occasioned medical care.

B. CMS prefers that the obligation be met by establishing an MSA. Failing to fulfill the future interest obligation can lead Medicare to refuse to pay for care until a plaintiff spends the settlement amount that CMS determines, which probably would be more than Medicare would accept to fund an MSA.

C. To establish an MSA, an amount representing reasonably anticipated future care costs is set aside in a trust to be disbursed as future accident related care is received.

D. An MSA is Medicaid countable unless it qualifies as a 42 U.S.C. 1396p(d)(4) exception trust.

E. Medicare has issued detailed protocols to determine a claimant's future care obligation in case of worker compensation, but there is almost no guidance in the liability settlement context although from time to time, Medicare has announced plans to address liability settlement MSAs soon.

F. We develop liability MSAs by starting with worker compensation guidelines, and modifying them in a reasonable manner to take account of differences (such as liability and insurance issues).

G. MSA administration is complicated, so most MSAs should be administered professionally. This can help lower the cost of care because professional administrators can negotiate care costs based on reasonable and customary protocols, whereas a layperson without professionals negotiating for her

might be charged retail rates.

H. In 2011, Medicare announced an alternate means to satisfy a plaintiff's obligation to protect Medicare's interest when settling a personal injury claim.

1. CMS will consider a plaintiff who doesn't use an MSA to satisfy the MSP obligation if the plaintiff obtains qualifying certifications from treating physicians stating that treatment has been completed as of the date of the settlement or verdict for the injuries on which the lawsuit arose, and that future medical items and services will not be required.

2. However, knowingly seeking certifications where a lawyer knows doctors still are treating or anticipate further treatment in the future could constitute fraud and violate lawyer ethics rules.

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Design & Administration of Special Needs Trusts

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I. DISABILITY BENEFITS

A. Disabled people potentially can qualify for several government benefits such as cash assistance, health care, housing, vocational training, and various other programs.

1. Disabled for purposes of various government disability benefits (including SSI, SSD, and Medicaid) means unable to engage in almost any kind of work (SS Disabled).

2. An individual is presumptively not SS Disabled if he/she is capable of earning at least an income threshold that varies depending on various circumstances and is inflation adjusted.

3. A former surgeon who suffers tremors that prevent him from operating but who can practice other kinds of medicine or teach is not SS Disabled but may be disabled for other purposes such as private disability insurance.

B. Federal Programs

1. Social Security Administration Programs

a. Supplemental Security Income (SSI) is cash assistance to or for people who are aged, blind, or disabled and have income and resources within program limits.

Disclaimer:
This outline was fully accurate when prepared in 2015 but has not been updated since. Therefore, before acting on an outline provision, confirm for yourself that it still applies.

b. Social Security Disability (SSD) is cash assistance to or for people who are disabled and have sufficient work history to qualify for SSD or who became disabled before age 22 and can qualify for SSD under a parent's work record. SSD has no income and resource limits but more than modest earned income usually indicates that a person isn't disabled.

2. Medicare is available to people with sufficient work history upon reaching age 65, after qualifying for SSD for two years, or upon contracting certain medical conditions.

a. Some Medicare benefits are free while others require premium payments.

b. Delaying enrollment in a Medicare part that requires a premium triggers additional fees unless alternative creditable coverage applies.

c. Medicare can be but isn't always available to people with Medicaid.

C. Federal/State Shared Programs

1. Medicaid

a. Medicaid is far and away the most commonly encountered shared program that benefits SS Disabled people. Medicaid also is available to aged and blind people, and the Affordable Care Act allows states to offer Medicaid to people with modest incomes. Limited Medicaid programs also are available to other classes of people like children and pregnant women. New Jersey and many other states provide Medicaid automatically to SSI recipients.

b. Medicaid is state administered and eligibility requirements and benefits vary to some extent from state to state.

c. To qualify for Medicaid, an individual must have income and resources within program limits.

d. Medicaid non-nursing facility level benefits (NNF) cover preventive and acute care in hospitals and the community. Medicaid nursing facility level benefits (NF) cover long term care in a nursing home, assisted living facility, or in the community.

e. To qualify for NNF Medicaid, an individual's income and resources must be very modest (but the Affordable Care Act allows for higher incomes in participating states). To qualify for NF Medicaid, an individual must show a need for long term care typically through issues with activities of daily living as well as satisfy income and resource limits which, while higher than for NNF Medicaid, still are quite modest.

f. When one spouse seeks NF Medicaid, finances of both spouses are taken into account even if the couple has a prenuptial agreement stating that funds shall be separate and spouses aren't liable for one another's expenses.

(1) While prenuptial agreement terms limiting spousal responsibility for one another's care are ignored for Medicaid purposes, the agreement still governs in case of divorce and for substantive law purposes

(2) Limited exceptions may apply where a married couple separates well before either spouse needs NF services such as where a couple splits in their 50s but doesn't divorce and the wife enters a nursing home in her 70s.

2. Other federal/state shared programs include SNAP (formerly called food stamps), certain housing aid, and certain energy aid.

D. State Programs

1. The New Jersey Department of Human Services Division of Developmental Disabilities provides various benefits to people who are developmentally disabled and their families. New Jersey Department of Human Services also provides some similar benefits to people with mental illness

   a. Benefits range from day programs to group homes, supervised apartments, counseling, family support services, respite care, and a host of other social aid.

   b. People who can afford to pay for certain DDD benefits (such as group home costs) and their legally responsible relatives (spouse, parent of a minor child) must do so.

   c. When a participant in certain DDD programs receives more than nominal amounts, DDD may claim against those funds for prior and ongoing care costs.

   d. DDD requires people who can qualify for Medicaid to do so and there is a special Medicaid community care waiver program for developmentally disabled people.

2. PAAD/Senior Gold- State funded prescription aid for seniors and SS Disabled people who meet financial requirements.

II. FINANCIAL ELIGIBILITY FOR DISABILITY BENEFITS

A. Many programs for disabled people limit eligibility based on income, resources or both (Means Tested Aid) including SSI, Medicaid, housing aid, group homes and other programs for people with developmental disabilities and mental illness, and PAAD/Senior Gold.

B. Receipts by a Means Tested Program participant, certain relatives, or a trust that isn't exempt are disqualifying.

1. Gifts, devises, inheritances, recoveries (settlements, awards, trial judgments, Etc.), equitable distributions, alimony, child support, and most other kinds of receipts can disqualify a recipient and family members for Means Tested Aid.

2. Lawyers who don't plan such receipts with government benefits in mind harm their clients and may risk malpractice liability.

III. TRUSTS & MEANS TESTED AID

A. Trust Principal Countable- The Social Security Administrations' Program Operations Manual System (commonly called "POMS") SI 01120.200.D. says that for SSI purposes a trust is a resource to an individual who can

1. Revoke or terminate the trust and then use the funds to meet his/her food or shelter needs,

2. Direct the use of the trust principal for his/her support and maintenance under the terms of the trust, or

3. Sell his/her beneficial interest in the trust.

B. Trust Principal Not Countable- SI 01120.200.D. also says that a trust is not an SSI resource where individual cannot revoke or terminate the trust or direct the use of the trust assets for his/ her own support and maintenance.

C. Trust Income Not Countable- SI 01120.200.D. says where principal of a trust isn't SSI countable to the trust beneficiary, undistributed trust income also isn't SSI countable to the beneficiary.

1. As a corollary trust income probably will countable where trust principal is countable although unusual drafting can split the two.

2. Generally, undistributed trust income isn't countable if the beneficiary has no legal right to access it for support, but special rules make income of certain beneficiary funded trusts countable subject to statutory exceptions.

D. Non-assignable Income Paid Into Trust- POMS SI 01120.200.D. also says that amounts that can't be assigned by law are income to the person entitled to payment even if they are paid directly into trust.

1. Thus, pensions subject to the Employee Retirement Income Security Act (ERISA) are income to the plan participant even if paid into a special needs trust or other kind of trust directly by plan because ERISA forbids assignment of pensions.

2. Similarly, statutes prohibit assignment in trust of Social Security and various other government benefits payments.

E. Alimony Paid Into Trust- Alimony payments into a trust also would be income to the former spouse where the spouse has a legal right to receive the payment or access it for support. However, if the payment is to be made directly into trust and the trust beneficiary has no right to receive the payment or access it for support, the payment in trust wouldn't be income. Thus, POMS SI 01120.200.G. notes that child support or alimony payments paid directly to a trust as a result of a court order, are not income, but are income if pursuant to an assignment that can be revoked.

IV. SPECIAL NEEDS TRUSTS TO PROTECT MEANS TESTED AID

A. A trust intended to protect Means Tested Aid may be called special needs trust/supplemental needs trust/supplemental benefit trust/or some other name depending who drafted it and which state's laws govern. Below special needs trust means SNT containing assets contributed by the beneficiary (e.g. personal injury settlement) while supplemental needs trust means SNTs funded solely by persons other than the beneficiary (e.g. devise directly into SNT under a parent's will).

B. A trust protects Means Tested Aid only if its income and/or resources are not available to the beneficiary for support. Thus, an SNT protects Means Tested Aid only if it is drafted and administered so that undistributed principal and income aren't resources or income to the beneficiary. However, the SNT still will be disqualifying if it isn't drawn in accordance with rules governing particular Means Tested Aid programs.

1. For instance to avoid SSI and Medicaid disqualification, a special needs trust must satisfy requirements under 42 U.S.C. §1396p(d)(4)(A), (B), or (C) and state counterparts that don't

apply to supplemental needs trusts.

2. However, even though an SNT satisfies special requirements under 42 U.S.C. §1396p(d)(4)(A), (B), or (C) and avoids SSI and Medicaid disqualification, it still can be disqualifying for developmental disability benefits that may have other requirements.

C. An SNT disqualifies a beneficiary for SSI, Medicaid (and some other Need Based Aid programs) to the extent the beneficiary has a legal right to access the SNT to fund his/her support. Thus, a trust that mandates distributions for support is disqualifying while a trust that leaves all distributions to the trustees' discretion may not be disqualifying.

D. It isn't clear whether a trust that says the trustees shall distribute for the beneficiary's health and support within the trustees' discretion has support obligations or is discretionary.

1. The 2011, New Jersey Supreme Court may have shed guidance in affirming the Appellate Division opinion *Tannen v. Tannen*, 416 *N.J. Super.* 248, 3 *A.3d* 1229, (*App. Div.* 2010), *aff'd*, 208 *N.J.* 409 (2011).

2. *Tannen* may indicate that trustees have no distribution obligation where a trust gives the trustees full discretion over distributions even if it also says the trustees shall distribute for health, support, maintenance, and education. However, it isn't clear whether the opinion applies generally to trusts with hybrid support/discretionary terms because the Appellate Division opinion says plaintiff conceded that the trust gave trustees total discretion and defendant couldn't force the trustees to make distributions to her. We don't know whether the opinion may have changed if plaintiff had maintained that the trust was obligated to distribute for the beneficiary's support.

3. The Tannen trust says:

> The Trustees shall pay over to or apply for the benefit of the beneficiary's health, support, maintenance, education and general welfare, all or any part of the net income therefrom and any or all of the principal thereof, as the Trustees shall determine to be in the beneficiary's best interests, after taking into account the other financial resources available to the beneficiary for such purposes that are known to the Trustees. The term "best interests" shall include, without limitation and in the Trustees' sole discretion as to need and amount, payments from the Trust to help meet educational expenses, medical expenses or other emergency needs of the beneficiary, to enable the beneficiary to purchase a home, and to enable the beneficiary to enter into a business or profession · The time or times, amount or amounts, manner and form in which said distributions shall be made, or sums so expended, shall be left to the sole discretion of the Trustees and shall be made without court order and without regard to the duty of any person to support such beneficiary....
>
> Notwithstanding any other provision in this Trust Agreement to the contrary, it is the express intention of the Grantors in creating this Trust that the beneficiary shall not be permitted, under any circumstances, to compel distributions of income and/or principal prior to the time of final distribution.

E. Of at least equal importance to avoiding disqualification, an SNT must be compatible with the beneficiary's individual needs. While an SNT must be drafted in a manner that won't disqualify the beneficiary for crucial government aid, the trust must not be so restrictive that it can't buy needed goods and services. For instance, a trust for a person with mental illness may be of little benefit if it can't pay for his housing in the community.

F. Well drafted SNTs are much more than mere forms drawn primarily to preserve Medicaid eligibility.

1. For instance, form trusts often prohibit a trust from funding support to ensure the trust isn't Medicaid disqualifying. SNTs should be sufficiently flexible to meet the beneficiary's needs. For instance, a trust that prohibits expenditures that can lead to a reduction of benefits may be precluded from funding housing costs (including rent, mortgage, property tax, property insurance when required by a lender, water, electricity, sewer, gas, heat, and garbage removal; including any portion of such costs included in condominium association charges). That kind of prohibition isn't necessary and may prevent a huge settlement from meeting a seriously disabled individual's goal

to live in a nice condominium.

2. A better approach is to draft an SNT so that the trust has no obligation to pay for support but doesn't prohibit desirable expenditures. However, the drafting must be is very tight to ensure the trust isn't obligated to pay for support, which would result in disqualification.

G. Supplemental needs trusts can be established in a will or stand alone, but stand alone often is preferable because it can be funded by different family members even while the grantor is living.

H. A special needs trust funded with a litigation recovery, worker compensation award, or other amount attributable to the beneficiary (such as certain divorce payments) is SSI and Medicaid disqualifying unless it complies with 42 U.S.C. §1396p(d)(4)(A) or (C).

1. A 42 U.S.C. 1396p(d)(4)(A) SNT is a traditional trust with just one disabled beneficiary while a (d)(4)(C) SNT is a pooled trust sponsored by a non-profit organization.

2. A 42 U.S.C. 1396p(d)(4)(A) SNT can be more flexible and allows the beneficiary to choose his own trustee but it may be more expensive to establish.

3. Both 42 U.S.C. 1396p(d)(4)(A) and (C) special needs trusts also must comply with applicable state requirements. For instance, New Jersey Medicaid regulations require special needs trusts to include numerous technical record keeping, reporting, and other requirements while Pennsylvania limits special needs trust expenditures. New York's Estates, Powers, and Trusts Law's supplemental needs trusts provisions nearly always should be included in New York supplemental needs trusts but would not be appropriate for a New Jersey trust. Similarly, New Jersey Medicaid regulation requirements shouldn't be included in New York trusts.

4. While structuring a settlement for a disabled plaintiff can provide tax and other benefits, it is almost never desirable to

entirely structure a settlement. While a case is pending, families often are forced to defer expensive purchase they greatly desire for lack of funds. Therefore, it is important to keep liquid sufficient settlement proceeds to meet pent up demand for such big ticket items as a disability modified van, disability modified bathroom, computers, adaptive technology, disabilities camps, etc..

5. Payback Requirements- 42 U.S.C. 1396p(d)(4)(A) requires a d4A trust to repay Medicaid when the beneficiary dies. Some advocates claim (and some courts have held) only Medicaid expenditures after establishment of the trust must be repaid. However, POMS SI 01120.203 prohibits trust provisions limiting the Medicaid payback period.

6. Parents and grandparents don't have inherent authority to place a descendant's assets/income in trust. A competent adult can authorize others to place his assets/income in trust such as via power of attorney.

7. Court authorization is required to place in trust assets/income of minor or adult who lacks capacity. Where parents place a minor or incapacitated child's funds in SNT without court authorization, the beneficiary should have a legal right to terminate and recover the trust. Therefore, the SNT should be SSI and Medicaid disqualifying (unless a court authorizes the trust after the fact).

8. 42 U.S.C. 1396p(d)(4)(A) does not permit a special needs trust to be established by the beneficiary. Acts by an agent acting under power of attorney are attributed to the principal. Therefore, an SNT established by an agent acting under power of attorney is treated as if established by the principal of the power of attorney.

I. The common law Doctrine of Worthier Title (DWT) makes a so-called irrevocable trust revocable when the same person is grantor and life beneficiary and the life beneficiary's heirs are the remainder

beneficiaries.

1. Social Security Administration guidance says a special needs trust that is revocable due to the DWT fails and, therefore, is SSI and Medicaid disqualifying.

2. A trust that names remainder beneficiaries can avoid the DWT, but NJ law automatically makes the grantor/life beneficiary's heirs where the life beneficiary lacks capacity and life beneficiary funds the trust. Consequently, in 2000, I drafted a statute on behalf of the Bar Association that says DWT doesn't apply to special needs trusts in New Jersey. The Social Security Administration recognizes the statute at POMS SI NY01120.200. However, a special needs trust can fail due to DWT if the SNT names as governing law one of the many states that still apply the DWT or the trust situs is changed from New Jersey to a state that applies the DWT.

J. As originally drafted, the Uniform Trust Code contained provisions that could jeopardize special needs trusts and supplemental needs trusts by forcing them to fund a beneficiary's support. Therefore I drafted a provision on behalf of the Bar Association that says the UTC bill currently under consideration in the New Jersey Legislature does not require a properly drafted special needs trust or supplemental needs trust to fund a beneficiary's support

V. SNT ADMINISTRATION

A. Even if undistributed SNT income and principal does not disqualify the beneficiary for Need Based Aid, SNT distributions can be disqualifying.

B. Amounts that an individual has a right to access and that are available to meet his/her support needs generally are SSI and Medicaid disqualifying. Other Need Based Aid programs have similar terms.

C. Since cash always can be used to fund the recipient's support, SNT cash distributions normally are income for purposes of Need Based Aid.

1. SNT cash distributions reduce SSI

2. Depending on the program, very small cash distributions may not affect eligibility for programs other than SSI.

3. More than modest SNT cash distributions usually are disqualifying.

D. Distributions in-kind usually don't constitute income for purposes of Need Based Aid unless they are certain high value assets, result from payments for food, shelter (i.e. rent, mortgage, property tax, property insurance when required by a lender, water, electricity, sewer, gas, heat, and garbage removal); including any portion of such costs included in condominium association charges), or are other items depending on the program.

E. In-kind support and maintenance (ISM) usually is treated as income equal to either ⅓ of the SSI federal benefit rate (FBR) or ⅓ the FBR + $20 even if true value is much higher.

F. The total value of ISM for a month is limited to approximately one third the FBR even though fair value can be much higher. Thus, it usually is preferable for an SNT to provide ISM than cash that the beneficiary uses to fund support.

G. Credit Cards- POMS SI 01120.201 provides that a trust's payment of a credit card bill for food or shelter provided to the beneficiary (e.g. restaurant charge) triggers in-kind support and maintenance income, but payments for charges other than food or shelter usually don't result in income. Thus, an SNT can provide "big ticket" items without jeopardizing the SNT beneficiary's Need Based Aid by paying vendors directly.

H. Contributions After Age 65- 42 U.S.C. 1396p(d)(4)(A) applies only to a trust established for an individual under age 65. POMS SI 01120.203 clarifies that a trust established per 42 U.S.C. 1396p(d)(4)(A) before the beneficiary reaches age 65 doesn't lose its exemption merely because the beneficiary reaches age 65. Nevertheless, contributions in trust after age 65 are not exempt in

testing SSI and Medicaid eligibility. However, per the POMS, typical trust earnings on pre-age 65 contributions in trust and periodic payments from pre-age 65 structured settlements aren't considered post-age 65 contributions in trust even if received by the trust after the beneficiary reaches age 65.

I. Exclusive Benefit- POMS SI 01120.201 says a 42 U.S.C. 1396p(d)(4)(A) qualifying trust must be for the exclusive benefit of the disabled beneficiary, which is more limited than the statutory language.

1. The POMS says trust payments of reasonable compensation for typical services rendered on behalf of the trust beneficiary don't violate the exclusive benefit rule.

2. The POMS goes on to say Social Security Administration ("SSA") staff shouldn't routinely question compensation amounts unless payment is to family or there is another reason to question reasonableness of compensation.

3. In late 2011, the POMS were revised to say a trust violates the exclusive benefit requirement where it may pay for the beneficiary's family to fly in to visit the beneficiary because the trust would then authorize expenditures that financially benefit the family. Responding to advocates' concerns, the Social Security Administration again revised the POMS by removing the example whereby flying in family would violate the exclusive benefit rule.

4. Finally, after meeting with advocates, SSA revised POMS SI 01120.201's exclusive benefit rule to strike a more reasonable balance authorizing payment of third party travel expenses–

a. when necessary for the trust beneficiary to obtain medical treatment; or

b. to visit a trust beneficiary who resides in an institution, nursing home, or other long-term care facility (e.g., group homes and assisted living facilities) or other

supported living arrangement in which a non-family member or entity is being paid to provide or oversee the individual's living arrangement. The travel must be for the purpose of ensuring the safety and/or medical well-being of the individual.

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