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Trusts & Estates Forum

Third-Party Trusts And A Client's Disabled Beneficiary

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Last month's Trusts and Estates Forum explored the use of a statutory benefit preservation trust (the Under 65 SNT) where an extraordinary event results in the disabling of an individual, and the individual subsequently receives a litigation award or settlement. Bove & Langa, *Protecting Personal Injury Awards with SNTs* (MLW March 11, 2002). But is not only the receipt of a personal injury award which gives rise to the attorney's need to understand benefit preservation trusts. The simple variables of life present many circumstances where a attorney is asked to advise a client on the best way to provide for a disabled individual. This part two of the authors' two part series focusing on the disabled individual will explore the situation where a "third party" (a parent, relative, or friend, for example) wishes to include a disabled individual within an estate plan.

When an attorney is asked to advise a client on the best way to provide for a disabled individual in the client's estate plan, the attorney is faced with a number of options. Since the objective in most cases is to provide benefits to the disabled individual from the client's estate without jeopardizing the disabled individual's right to public benefits to which he may be entitled, it is important to structure the plan in a way to meet that objective. The uninitiated may simply advise the client to provide an outright bequest to the disabled individual, but this will almost certainly disqualify the individual from public benefits, since many public benefit plans base eligibility upon the amount of assets a beneficiary owns. For example, to be eligible to receive Medicaid benefits under the MassHealth program, a disabled individual may not have more than $2,000 of "countable" resources. 130 C.M.R. 520.003.

An attorney's knee-jerk reaction to the resource limitation might be to simply to advise the client to omit the disabled individual altogether as a beneficiary of the client's estate plan. This idea isn't much better, as it deprives the disabled individual of the potential benefits that may be offered through use of his "share" of the client's estate assets, and it discounts the emotional toll to the client who is advised to turn his back on a person he wishes to benefit.

A third option that is commonly, though unadvisedly, used is to advise the client to give the disabled individual's share to another beneficiary, typically a sibling, with the informal understanding that the sibling will use the funds to benefit the disabled beneficiary. But what if the surrogate beneficiary suffers a divorce? Or decides the funds can be put to "better" use? Or dies? Clearly the proxy inheritance is a bad idea.

None of the three plans above offers a suitable, reliable way to provide for the disabled individual without a loss of benefits or potentially a loss of the estate assets themselves. Between these extremes, however, lies the third-party trust, which can be structured to preserve the public benefits that may be available to the individual, while at the same time providing resources to improve the individual's quality of life and supplemental needs.

Reference to a "third-party trust" (TPT) simply means a form of a benefit preservation trust that is established and funded by someone other than the beneficiary. One of the most significant advantages to the TPT is that it can enjoy the protection offered by the spendthrift trust rules, and it is this concept in large part, that is responsible for the protection it offers in the case of public benefits, and is a significant difference between the TPT and the Under 65 SNT, which is funded with the disabled individual's own assets.

Briefly, the spendthrift trust rules provide that, where a trust is established and funded by someone other than the beneficiary, and where the trust contains an anti-alienation ("spendthrift") provision, a beneficiary of such a trust cannot anticipate or force a distribution that is not mandated by the trust (unless the trust states otherwise). Hence, the assets of a spendthrift TPT under which all payments to a beneficiary are made at the discretion of the trustee are protected since neither the beneficiary nor a creditor of the beneficiary may force a distribution or reach the trust assets. Broadway National Bank v. Adams, 133 Mass. 170 (1882); see also Nichols V. Eaton, 91 U.S. 716 (1875).

An example taken from the facts of the classic Escher case may be illustrative. In re Escher, 407 N.Y.S.2d 106 (Sur. Ct. Bronx Co. 1978), *aff'd*, 426 N.Y.S.2d 1008 (N.Y. App. Div. 1980), *aff'd*, 420 N.E.2d 91 (1981). There, Mr. Escher wished to provide for one of his children who was psychiatrically impaired, and did so by placing her share of his estate within a discretionary spendthrift trust for her benefit during her lifetime, directing that the trust property be used only in the event of her "illness, accident, or other emergency." Id. 407 N.Y.S.2d at 108. The government subsequently sought to be reimbursed out of the trust for the cost of providing institutionalized care to this disabled child for a period of over thirty years. The court found that the government-creditor could not reach the assets of the trust created by the disabled individual's parent because it found the intent of the parent was to simply provide for the disabled individual's supplemental needs, and not to pay for the cost of care provided by the government.

Assuming the attorney understands that a TPT is recommended for the client who wishes to provide for the disabled beneficiary. let's consider the traps awaiting the unwary. As noted above, many public benefit programs will not provide benefits if the disabled individual has resources of his own. Resources would not only include assets the individual holds in his own name but also assets in a trust which are reachable by the beneficiary, either directly or through court action. See, e.g. the law governing "Medicaid Qualifying Trusts" (a misnomer) at 42 U.S.C. §1396a(k); 130 CMR 520.022.

What is considered directly reachable by a disabled individual is somewhat self-evident. If a trust provided that Tom (a disabled individual) could withdraw up to $11,000 per year or was entitled to all the income, then the $11,000 or the income, as the case may be, will be counted as an available resource in considering Tom's eligibility for benefits, whether or not it is distributed to him.

Regarding trust assets which are considered indirectly reachable by the disabled beneficiary through court action, consideration must be taken of the so-called "support trusts". For example, a support provision is one where the trustee is directed to provide for Tom's support. The income (and/or principal if the trust so provides) would be considered an available resource, since a creditor providing support for Tom could reach the trust assets through legal action, notwithstanding the fact that the trust may contain a spendthrift provision. McNiff V. Olmsted County Welfare Dept., 176 N.W. 2d 888 (Minn. 1970); Restatement (Second) of Trusts 154 (1959). Support trusts are generally not a good idea for a disabled beneficiary.

Not the same as "support trusts" but similar are discretionary trusts which provide "standards" to guide the trustee in exercising her discretion to make distributions. These standards can also result in disqualification problems, even where a disabled individual has met the initial eligibility requirements. For instance, the trust may direct the trustee to make discretionary distributions for Tom's "health and maintenance" or "comfort and well-being". In these cases the trustee in acting reasonably may be obliged to provide benefits to Tom which would otherwise be provided by the public benefit program, perhaps against the intention of the client. And even where the trustee acts in good faith and is mindful of the public benefit program, she may make a distribution that constitutes or can be used to acquire something that falls into the category of "food, clothing, or shelter", thus possibly reducing Tom's benefits under the program. See Emily Starr, *Special Needs Trusts Help Preserve Public Benefits* (MLW December 2, 2001).

In an effort to draft around this potential "standards" problem some advisors will include a trust provision that expressly prohibits the trustee from making a distribution that would or could constitute food, clothing, or shelter. For reasons stated in part one of this series, the authors strongly recommend against this approach. A related strategy that the authors also discourage is the forfeiture approach, which calls for a complete forfeiture of the disabled individual's beneficial interest in the client's trust if the assets or income of the trust are treated as a resource to the beneficiary which would disqualify him from receiving benefits. Such a drastic tactic is simply not necessary as we will see.

It is well settled in the development of third party trust law that where public benefits are involved that a properly drafted TPT which is fully discretionary as to distributions will not, by itself, cause a reduction or loss of benefits for a discretionary beneficiary. Clifton B. Kruse, *Third Party and Self-Created Trusts* (ABA Third Edition). Further, this arrangement can be even more protective where there are multiple trust beneficiaries (a "pot" trust) due to the trustee's obligation to take into consideration the rights of all the beneficiaries and not simply the needs of the disabled individual. However, note that where a "pot trust" is utilized the careful drafter will provide that the trustee has the power to exclude one or more beneficiaries from the exercise of her discretion. Otherwise, a distribution to one beneficiary may trigger an obligation to distribute to all the beneficiaries, including the disabled beneficiary. (Note also there may be generation-skipping tax issues if any of the beneficiaries are two or more generations below the settlor.)

A question that often poses a dilemma is who should be the trustee of the TPT. Usually, if a parent is able to serve, it is a good idea if the parent acts at least as co-trustee, since a parent would be well aware of the needs of the disabled individual. However, if the parent is also the creator of the trust, the trust assets will likely be included in the parent's estate. IRC Sections 2036 and 2038. If the parent does not have a taxable estate then this is not a problem.

After the parents, siblings are often seen as good candidates. There are, however, considerations as to gift tax implications if the sibling/trustee is also a remaindermen, as well as motivation issues (in making or withholding distributions) for the same reason. All in all, most trust practitioners who understand the special requirement of trusts for disabled individuals recommend that at least one of the trustees be an independent party, often a professional such as an attorney or accountant, or a corporate trustee.

Another perplexing question that arises in drafting a TPT is whether the trustee, in exercising her discretion, must or may consider other sources of benefits or resources available to the disabled individual. In the authors' opinion, the trust should be drafted giving the trustee the broadest discretion (without standards) and affirmatively state that the trustee need not consider other resources available to the disabled beneficiary. If you do not negate the need to inquire, the inherent duty of a trustee to act reasonably may impose the duty of inquiry on the trustee of an otherwise silent trust. Scott, *The Law of Trusts* §187 (William Fratcher, ed. 4th ed. Little, Brown 1988).

Further, if consideration of outside resources is even suggested, or if the trust is silent as to the matter, many advisors as well as most professional trustees firmly believe it will have an effect on the exercise of discretion, perhaps in a manner not intended by the drafter, or the client. As noted in part one of this series, and above, it may be that a trust distribution (for food, shelter, and clothing, for example) which, in fact, does affect an individual's eligibility for public benefits (such as SSI benefits) will nevertheless have an overall favorable result to the disabled individual when one considers the amount of the distribution (which may be substantial) compared to the temporary reduction in public benefits (which is not dollar for dollar). Therefore, if the trustee was *required* to consider the public benefits available to the disabled beneficiary, in some cases the best course of action for such beneficiary will be precluded.

As should be evident, a trustee of even a properly drafted fully discretionary trust which has one or more beneficiaries who are receiving public benefits is well-advised to consult with an expert on the affect of such distributions. But even this consultation may not satisfy an overly cautious trustee. While a family member or family attorney who is trustee may be willing to exercise broad discretionary powers in such a case, it is not uncommon for a corporate trustee to be unwilling to act without indemnification or court instructions. Often this can cause family disputes and affect the benefit status of the disabled individual. This issue can be avoided by providing in the trust for the appointment of a "protector" or outside advisor who could have the power to control distributions to the disabled individual.

While a full discussion of the role of a protector will be reserved for a future column, suffice it to say that in the case of the TPT with a corporate trustee, the protector could have the power to veto any distributions to the disabled individual. In effect, the corporate trustee would be unable to make a distribution without the consent of the protector, thus protecting not only the beneficiary's right to benefits, where appropriate, but also protecting the corporate trustee. Of course, provisions regarding the appointment of the protector and any successor must be carefully thought out, but they are by no means unusual.

Perhaps one of the most important provisions to consider including in a TPT is a power to amend. In a self-settled benefits preservation trust the inclusion of such a power would be fatal for purposes of qualifying for benefits, but in a TPT benefits preservation trust, the inclusion of such a power can save the day. That is, in the event of a change in the law or a change in circumstances of the disabled beneficiary, or an attack on the trust, the powerholder (which could be the trustee or a someone other than the creator of the trust) can simply amend the trust in a manner to deal with the problem. This is far superior to a forfeiture provision, for example, which causes the trust to self-destruct, effectively defeating the very purpose of the trust and the intentions of your client.

So, in summary, what are the main provisions to consider in a TPT to benefit a disabled individual? The TPT will be fully discretionary with no mention of support. The discretion of the trustee will not be guided by standards, stated restrictions, or admonitions regarding disqualifying distributions. There will not be a forfeiture or self-destruct provision. Instead, the TPT will be fully discretionary, will have, where possible, multiple beneficiaries, will grant a special power to amend in an independent person, and will provide for a protector. It may be funded by a lifetime gift from the client (or some other third party), the proceeds of a life insurance policy, a distribution from the client's estate or from a trust, or all of the above. If the TPT is carefully structured, the income and assets can provide benefits for the disabled beneficiary, without jeopardizing the disabled person's eligibility to receive public benefits. And, since the TPT may not be depleted within the disabled beneficiary's lifetime, the properly drafted TPT will provide for a gift over to the other members of the client's family upon the disabled individual's death.