

**HANDLING A SPECIAL
NEEDS TRUST—A
HANDBOOK FOR ARIZONA
TRUSTEES (2007 Edition)**

FLEMING & CURTI, PLC

330 N. Granada Ave.
Tucson, Arizona 85701

Handling a Special Needs Trust

Table of Contents

I. Introduction and definition of terms	
Grantor	2
Trustee	2
Beneficiary	2
Disability	2
Incapacity	3
Revocable Trust	3
Irrevocable Trust	3
Social Security Disability Insurance	3
Supplemental Security Income	3
Medicare	4
Medicaid	4
AHCCCS	5
ALTCS	5
II. The Most Important Distinction	
“Self-Settled” Special Needs Trusts	6
“Third Party” Special Needs Trusts	7
The “Sole Benefit” Trust	7
III. The Second Most Important Distinction	
SSDI/Medicare Recipients	8
SSI/Medicaid Recipients	9
Other Means-Tested Benefits Programs	9
IV. Eligibility Rules for Means Tested Programs	
Income	10
Assets	13
V. “I Want to Buy a (Pay For) ...”	
Home and Upkeep	14
Utilities and Computers	15
Clothing	16
Vehicle, Insurance, Maintenance, Gas	16
Pre-paid Burial/Funeral Arrangements	16
Tuition, Books, Tutoring	17
Travel and Entertainment	17
Household Furnishings and Furniture	17
Durable Medical Equipment	17
Care Management	18

	Therapy, Medications, Alternative Treatments	18
	Taxes	18
	Legal Fees, Guardianship Fees	18
VI.	Trust Administration and Accounting	
	Trustee’s Duties	19
	No self-dealing	19
	Impartiality	19
	Delegation	20
	Investment	20
	Accounting Requirements	20
	Reporting to Social Security	21
	Reporting to Medicaid/AHCCCS/ALTCS	22
	Reporting to the Court	22
	Wrapping up the Trust	23
VII.	Income Taxation of Special Needs Trusts	
	“Grantor” Trusts	24
	Tax ID numbers	24
	Filing tax returns	25
	Non-Grantor Trusts	25
	Tax ID numbers	25
	Filing tax returns	26

Handling a Special Needs Trust

A Handbook for Trustees

I. Introduction and definition of terms

“Special Needs” trusts are complicated to understand and administer. They are like other trusts in many respects—the general rules of trust accounting, law and taxation apply—but unlike more familiar trusts in other respects. The very notion of “more familiar” types of trusts will, for many, be amusing—most people have no particular experience dealing with formal trust arrangements, and special needs trusts are often established for the benefit of individuals who would not otherwise expect to have experience with trust concepts.

The essential purpose of a special needs trust is usually to provide some benefit to an individual without disqualifying him or her from eligibility to receive public benefits. Obviously, one of the central requirements for the trustee of a special needs trust will be to understand what public benefits programs might be available to the beneficiary and how receipt of income (or direct purchase of goods or services) might affect eligibility. Because there are numerous programs, competing (and sometimes even conflicting) eligibility rules and at least two different types of special needs trust to contend with, the entire area is fraught with opportunities to make mistakes. Because the stakes are often so high—the public benefits programs may well be providing all the necessities of life to the beneficiary—a good understanding of the rules and programs is critically important.

Before delving into a detailed discussion of special needs trust principles, it might be useful to define a few terms:

- A. **Grantor** (sometimes “Settlor” or “Trustor”)–the person who establishes the trust. There might be more than one grantor for a given trust. Special needs trusts can make this term more confusing than other types of trusts, since the true grantor for some purposes may not be the same as the person signing the trust instrument. If, for example, a parent creates a trust for the benefit of a child with a disability, and the parent’s own money funds the trust, the parent is the grantor. In another case, where a parent has established a special needs trust to handle settlement proceeds from a lawsuit filed on behalf of the child with disabilities, the child will usually be the grantor, even though he or she did not decide to establish the trust, sign any trust documents or make any arrangements to transfer money into the name of the trust.
- B. **Trustee**–the person who manages trust assets. Once again, there may be two (or more) trustees acting at the same time. The grantor(s) may also be the trustee(s) in some cases. The trustee may be a professional trustee (such as a bank trust department, or a lawyer), or may be a family member or trusted adviser–though it may be difficult to qualify a non-professional to serve as trustee.
- C. **Beneficiary**–the person for whose benefit the trust was established. The beneficiary of a special needs trust will usually (but not always) be disabled. While a beneficiary may also act as trustee in some types of trusts, a special needs trust beneficiary will almost never be able to act as trustee.
- D. **Disability**–for most purposes involving special needs trusts, “disability” refers to the standard set out for Social Security Disability Insurance and Supplemental Security Income benefits–the

inability to perform any substantial gainful employment.

- E. **Incapacity** (sometimes **Incompetence**)—although these terms are not interchangeable, for our purposes they may both refer to the inability of a trustee to manage the trust, usually because of mental limitations. Incapacity is usually important when applied to the trustee, since the trust will ordinarily provide a mechanism for transition of power to a successor trustee if the original trustee becomes unable to manage the trust. Incapacity of a beneficiary may sometimes be important as well. Not every disability will result in a finding of incapacity; it is possible for a special needs trust beneficiary to be disabled but not mentally incapacitated.
- F. **Revocable Trust**—refers to any trust which is, by its own terms, revocable and/or amendable. Most trusts in common use today are revocable, but special needs trusts are usually irrevocable.
- G. **Irrevocable Trust**—means any trust which was established as irrevocable (that is, no one reserved the power to revoke the trust) or which has become irrevocable (for example, because of the death of the original grantor).
- H. **Social Security Disability Insurance**—sometimes referred to as SSDI or SSD, this benefit program is available to individuals with a disability who either have sufficient work history prior to becoming disabled or are entitled to receive benefits based on a parent's work history. There is no "means" test for SSDI eligibility, and so special needs trusts may not be necessary for some beneficiaries—they can qualify for public benefits even though they receive income or have available resources.
- I. **Supplemental Security Income**—better known by the initials SSI,

this benefit program is available to low-income individuals who are disabled, blind or elderly and have few assets. SSI eligibility rules form the basis for most other government program rules, and so they become the central focus for much special needs trust planning and administration.

- J. **Medicare**—one of the two principal health care programs operated and funded by government—in this case, the federal government. Medicare benefits are available to all those age 65 and over (provided only that they would be entitled to receive Social Security benefits if they chose to retire, whether or not they actually are retired) and those who have been receiving SSDI for at least two years. Medicare eligibility may forestall the need for or usefulness of a special needs trust, though Medicare recipients without substantial assets or income may find that they have a difficult time paying for medications (which historically have not been covered by Medicare but began to be partially covered in 2004) or long-term care (which remains largely outside Medicare’s list of benefits).
- K. **Medicaid**—the second major government-run health care program. Medicaid differs from Medicare in three important ways: it is run by state governments (though partially funded by federal payments), it is available to those who meet financial eligibility requirements rather than being based on the age of the recipient, and it covers all necessary medical care (though it is easy to argue that Medicaid’s definition of “necessary” care is too narrow). Because it is a “means-tested” health care program, its continued availability is often the central focus of special needs trust administration. Because Medicare covers such a small portion of long-term care costs,

Medicaid eligibility becomes centrally important for many persons with disabilities.

- L. **AHCCCS**—the Arizona Health Care Cost Containment System is Arizona’s version of Medicaid. It differs from Medicaid in other states primarily in the way medical care is actually provided. AHCCCS utilizes a managed-care approach, under which recipients are signed up for one of several available care provider networks once eligibility is determined. Eligibility rules for AHCCCS are essentially identical to Medicaid eligibility rules in other states. A number of other states (notably Tennessee) have adopted similar service delivery options, so AHCCCS is no longer unique or even all that unusual.
- M. **ALTCS**—the Arizona Long Term Care System is an administrative division of AHCCCS. ALTCS provides care for individuals with disabilities and limited financial resources in institutions, in the home (though the benefits here may be sharply limited) and in community settings like adult care homes and assisted living facilities. Eligibility for ALTCS is based on federal Medicaid rules, with a few state-specific variations.

II. **The Most Important Distinction**

Two entirely different types of trusts are usually lumped together as “special needs” trusts. The two trust types will be treated differently for tax purposes, for benefit determinations and for court involvement. For most of the discussion that follows it will be necessary to first distinguish between the two types of trust. The distinction is further complicated by the fact that the grantor (the person establishing the trust, and the easiest way to distinguish between the

two trust types) is not always the person who actually signs the trust document.

A. **“Self-Settled” Special Needs Trusts**

Some trusts are established by the beneficiary for the purpose of retaining or obtaining eligibility for public benefits. The beneficiary might, for example, have received an outright inheritance, or won a lottery. By far the most common source of funds for “self-settled” special needs trusts, however, is proceeds from a lawsuit—often (but not always) a lawsuit over the injury that resulted in the disability.

A given trust may be treated as having been established by the beneficiary even if the beneficiary is completely unable to execute documents, and even if a court, or a family member, or a lawyer representing the beneficiary actually signed the trust documents. The key test in determining whether a trust is self-settled is to determine whether the beneficiary had the right to outright possession of the proceeds prior to the action establishing the trust. If so, public benefits eligibility rules will treat the beneficiary as having set up the trust even though the actual implementation may have been undertaken by someone else acting on their behalf. Virtually all special needs trusts established with funds recovered in litigation will be “self-settled” trusts.

Self-settled special needs trusts are different from third party trusts in two important ways. First, self-settled trusts must include a provision directing the trustee to pay back anything the state Medicaid program has paid for the beneficiary upon the death of the beneficiary or termination of the trust. Second, the rules governing permissible distributions for self-settled special needs trusts are significantly more restrictive than those controlling third party special needs trusts.

Because Social Security law specifically describes self-settled special needs trusts, these instruments are sometimes referred to by the statutory

section authorizing transfers to the trusts and directing that trust assets will not be treated as available for SSI purposes. That statutory section is 42 U.S.C. §1396p(d)(4)(A), and so self-settled special needs trusts are sometimes called, simply, “d4A” trusts.

B. “Third Party” Special Needs Trusts

The second type of special needs trust is one established by someone other than the person with disabilities (usually, but not always, a parent). It is not correct to say that all trusts holding inheritances or gifts are “third party” trusts; if the inheritance or gift is outright, then the individual had the right to receive the funds prior to establishment of the trust and it will therefore be treated as self-settled. Parents, grandparents and others with the foresight to leave funds in a third party special needs trust will provide significantly better benefits to a beneficiary with disabilities.

C. The “Sole Benefit” Trust

Although there are two primary types of special needs trusts, there is actually a third, much less frequently seen type to be aware of. Because Medicaid rules permit applicants to make unlimited gifts to or “for the sole benefit of” disabled children or spouses, some individuals with assets may choose to establish a special needs trust for the child with disabilities in hopes of securing eligibility for Medicaid for both the grantor and the beneficiary. Arizona, like a number of other states, is very restrictive in its interpretation of the “sole benefit” requirement, so that such trusts are seen rarely. In many ways they look like a hybrid of the two other trust types; they may be taxed and treated as third party trusts but require a payback provision like a self-settled trust (at least in some states, including Arizona).

III. The Second Most Important Distinction

Once the type of trust is determined, the next important issue is the type of government program providing benefits. Some programs (like SSDI and Medicare) do not impose financial eligibility requirements; a beneficiary receiving income and all his or her medical care from those two programs might not need a special needs trust at all, or might benefit from more flexibility given to the trustee. A recipient of SSI and/or Medicaid, however, may need more restrictive language in the trust document and closer attention on the part of the trustee.

A. SSDI/Medicare Recipients

Neither Social Security Disability Insurance benefits nor Medicare are “means tested.” Consequently it may be unnecessary to create a special needs trust for someone who receives benefits from those two programs. After twenty four months of SSDI eligibility the beneficiary will qualify for Medicare benefits as well, so it may be appropriate to provide special needs provisions to get the SSDI recipient through that two-year period, during which he or she may rely on Medicaid/AHCCCS/ALTCS for medical care. Restrictive special needs trust language may actually work against an SSDI beneficiary if it prevents distribution of cash to the beneficiary in all circumstances; an SSDI recipient will almost always benefit from broad language giving more discretion to the trustee.

Some SSDI/Medicare recipients may also receive SSI and/or Medicaid benefits. It may be critically important for those individuals to have strict special needs language controlling use of any assets or income that would otherwise be available. As the Medicare prescription drug benefit evolves over the next few years, this concern may be somewhat lessened—but for the moment it remains true that availability of the drug coverage provided by Medicaid is critically important to many Medicare recipients.

Even an SSDI/Medicare beneficiary who does not receive any SSI or

Medicaid benefits may be a good candidate for special needs trust planning. Future developments in public benefits programs are uncertain, but constant budget pressure may well make benefits now taken for granted completely or partially indexed to income and/or assets in the future. Medical conditions also change, of course, and some persons with disabilities who presently receive adequate support from Medicare may one day become dependent on Medicaid for services not available under Medicare—like long term care.

B. SSI/Medicaid Recipients

Most special needs trust beneficiaries are eligible for (or seeking eligibility for) Supplemental Security Income payments. Receipt of SSI payments automatically qualifies one for Medicaid (AHCCCS) eligibility. Many other government programs explicitly rely on SSI eligibility rules, as well, so that SSI eligibility rules become the central concern for much of the administration of most special needs trusts.

C. Other Means-Tested Benefits Programs

Section 8 housing subsidies, Temporary Aid to Needy Families (TANF), state supplements to SSI, Veteran's benefits, and other government benefits programs also play important roles in the care of many individuals with disabilities. Because the welter of eligibility programs is confusing and the reach of most other programs is not as broad as those described in detail here, those other programs are not described in detail. In analyzing the proper approach to establishment or administration of a special needs trust, however, care should be taken to consider all the available program resources and restrictions on use of trust funds mandated by those programs.

IV. Eligibility Rules for Means Tested Programs

As previously noted, the primary program with financial eligibility

restrictions is SSI, the Supplemental Security Income program. Because the concepts are central to understanding of other eligibility rules, and because many other programs explicitly utilize SSI standards, the SSI rules become the most important ones to understand. They are generally described here, with a few notations where other programs (particularly long-term care Medicaid, or ALTCS) differ from the SSI rules.

A. **Income**

SSI eligibility requires limited income and assets. SSI rules have a charmingly simple way of distinguishing between income and assets; money received in a given month is income in that month, and the portion of that income remaining on the first day of the next month becomes an asset.

Any unearned income reduces the SSI benefit by the amount of the income, so investment income simply reduces the benefit dollar for dollar. Earned income may be treated differently, especially for a transition period designed to encourage SSI recipients to return to the workforce. Keeping in mind that disability is defined as “unable to perform any substantial gainful employment,” it is easy to see that any significant amount of earned income will eventually imperil SSI eligibility and, since trust administration does not usually involve earned income in any event, we will not attempt to deal with those issues here.

There are, however, several special SSI income rules that require specific mention. An SSI recipient is permitted to receive a small amount of income (currently \$20 per month) without having to report it as income. That amount is sometimes referred to as the SSI “disregard” amount.

SSI also has a concept of “in-kind support and maintenance” (ISM) that is central to much understanding of special needs trust administration. Any direct payment from a third party (including a trust) for necessities of life—food or

shelter (note that the federal government deleted “clothing” from the list of necessities in March, 2005)–will be treated as income, albeit subject to special rules for calculating its effect.

The effect of ISM on SSI benefits is different from the effect of cash distributions. Where the cash payments reduce the SSI payment dollar for dollar, ISM reduces the benefit by the lesser of the fair market value of the items provided or an amount calculated by dividing the maximum SSI benefit by three and adding the \$20 disregard amount.

For 2007 the maximum federal SSI benefit for a single person is \$623. One-third of that amount is \$207.67, and so the maximum reduction in benefits caused by ISM is \$227.67 per month. The meaning of that confusing collection of information is best illustrated using an example (CAUTION: some states provide SSI supplemental payments that affect this calculation).

Consider John, who is disabled as a result of his serious mental illness. He has no work history, and he does not qualify for SSDI. He is an adult, living on his own. He qualifies for the maximum SSI benefit of \$603; he lives in a state which does not provide an SSI supplement.

If John’s mother gives him \$50 per month (for food and cigarettes), he is required to report that as income each month. Although SSI may take two or three months to accomplish the adjustment, the program will eventually withhold \$50 from his benefit for each month in which his mother makes a gift to him. The same result will obtain if John’s mother is trustee of a special needs trust for John and the funds come from that trust.

If, however, John’s mother does not give him the \$50 directly but instead purchases \$30 worth of food and \$20 worth of cigarettes each month, only the former will affect his SSI payment–reducing it by \$10. If she purchases \$20 worth of food and \$30 worth of cigarettes, there will be no effect at all–the food

purchase is within the disregard amount. Similarly, if she purchases \$20 worth of cigarettes and \$30 worth of movie tickets, there will be no effect—provided that the movie tickets can not be turned in for cash (because if they can, John could—even if he does not—convert the movie tickets into payment for food or shelter).

In other words, the effect of John's mother's payments to him or for his benefit changes with the nature of her payments. Any cash she provides to him (over the \$20 monthly amount ignored by SSI) reduces his SSI payment directly. Direct purchase of items other than food or shelter do not affect his SSI, so long as the purchased items can not be converted to food or shelter. Finally, any payment she makes for food or shelter reduces his SSI check as well.

Now suppose that John's mother decides to give up on trying to work around the strictures of SSI rules, and she simply pays his rent at an adult care facility that provides his meals. Assume that the facility costs her \$1500 per month, which she pays from her own pocket. Because of the ISM rules, John's SSI benefit will be reduced by \$227.67 per month, and so his SSI check will be \$395 (because of rounding). Critically, however, John will still qualify for Medicaid benefits because he receives **some** SSI. If the adult care home payment comes from a special needs trust for John's benefit the same result will occur. Incidentally, the same result will also obtain if John's mother simply takes him in and allows him to live and eat with her without charging him rent.

Now assume that John does have a work history, and that he qualifies to receive \$400 per month from SSDI. Because he has been receiving SSDI for more than two years, he also qualifies for Medicare. Because his income is less than \$623, he continues to receive \$223 in SSI benefits, and qualifies for Medicaid as well (we will ignore the effect of the QMB and SLMB programs, and of the Medicare Part B premium which would ordinarily be withheld from his

SSDI check). Now if John's mother pays his rent at the adult care home, or takes him into her own home, he will lose his SSI altogether—since he is receiving less than \$227.67 per month from SSI, the effect of the ISM rules will be to knock him off the program. Unless he separately qualifies for Medicaid, he will also lose his coverage through that program.

The income strictures are the same or similar for other programs, with one important exception. In some, but not all, states (including Arizona) eligibility for long term care Medicaid (Arizona's ALTCS) is also dependent on income. The income test for ALTCS is set at 300% of the maximum SSI benefit, so an individual with less than \$1869 in monthly income may qualify for ALTCS even though he or she would not qualify for SSI.

The ALTCS program in Arizona also believes that it can limit expenditures from self-settled special needs trusts, and can require amendments to the language of those trusts. While a good argument can be made that the program does not have that ability, as a practical matter the trustee of a self-settled special needs trust will have to either litigate that issue or acquiesce in ALTCS' demands. Specific state statutory authority for the ALTCS position is set out at A.R.S. §36-2934.01(B), which was significantly amended in 2004 (and, surprisingly, mostly to favor beneficiaries rather than to make the rules more restrictive).

B. Assets

The limitation on assets for SSI eligibility may be somewhat easier to master, or at least to describe. A single person must have no more than \$2,000 in available resources in order to qualify for SSI. Some types of assets are not counted as available, including the beneficiary's home, automobile, household furnishings, prepaid burial amounts plus up to \$1500 set aside for funeral expenses (or life insurance in that amount), tools of the beneficiary's trade, and a

handful of other, less important, items. Each of these categories of assets is subject to special rules and exceptions, so it is easy to become tangled in the asset eligibility structure.

V. “I Want to Buy a (Pay For) ...”

What do these complicated rules mean for expenditures from a special needs trust? There are a number of specific items that frequently recur¹:

A. Home and Upkeep

Keep in mind that SSI’s in-kind support and maintenance (ISM) rules deal specifically with payments for “food and shelter.” The Social Security Administration includes only these items:

1. Food
2. Mortgage (including property insurance **required** by the mortgage holder)
3. Real property taxes (less any tax rebate/credit)
4. Rent
5. Heating fuel
6. Gas
7. Electricity
8. Water
9. Sewer
10. Garbage removal

¹ Note that the ALTCS program, as described above, insists that it has the authority to further limit expenditures from special needs trusts. This concerns only self-settled trusts for beneficiaries who receive ALTCS but not SSI benefits, so the effect of the ALTCS rule is sharply limited—but for those trusts that are affected, the result can have profound consequences. The list of approved expenditures for ALTCS-qualified trusts is set out in A.R.S. §36-2934.01(B).

The rules make special note of the fact that condominium assessments may in some cases be at least partly payments for water, sewer, garbage removal and the like.

In other words, a payment for rent will implicate the ISM rules, as will monthly mortgage payments. Purchase of a home, whether in the name of the beneficiary or the trust, will not cause loss of SSI (although it may reduce the beneficiary's SSI payment for the single month in which the home is purchased).

Although it is not completely logical, payment of utilities, taxes or mortgage from the trust for a home owned by the beneficiary or held in the trust and occupied by the beneficiary without payment of rent **will** be treated as ISM, so it may sometimes make more financial sense to purchase any home in the trust's name rather than the beneficiary's. Depending on the individual circumstances, however, purchase of a home in the trust's name may subject it to a "payback" requirement on the death of the beneficiary. The complicated interplay of trust rules, ISM definition and home ownership make this area of special needs trust administration particularly fraught with difficulty.

As with some other items, Arizona's treatment of distributions from special needs trusts may differ from the Social Security interpretation—especially when the beneficiary of a self-settled trust is eligible for ALTCS benefits. Arizona requires that any purchase of a home by such a trust result in title being held in the trust's name—thereby ensuring that the State will at least receive the proceeds from residence on the death of the beneficiary.

B. Utilities and Computers

Other than those utilities listed in the Social Security Administration's ISM definition there is no federal limitation on utility payments. In other words, the trust can pay for cable, telephone, high-speed internet connection, newspaper, and other "utilities" not on the list. The trust can also provide a computer for the

beneficiary, plus software and upgrades.

C. Clothing

Until March, 2005, the definition of ISM included “clothing” along with food and shelter. The federal government finally figured out that the cost of monitoring the relatively small expenditures involved in purchases of clothing exceeded any savings to the system, and removed clothing from the list of questioned in-kind purchases. That means that a special needs trust can pay for the beneficiary’s clothing needs without any repercussions, whether the clothing in question is special garments related to the disability or just ordinary street clothes.

D. Vehicle, Insurance, Maintenance, Gas

Purchase of a vehicle and maintenance (including gas and insurance) is permitted under federal law. Note that there is a mechanical difficulty in providing gasoline without providing cash that could be converted to food or shelter. One technique which has worked well has been to arrange for the beneficiary to have a gas-company credit card. Because eligibility for such cards is easier to meet, and because the cards can not be used to purchase groceries, administration of the credit account is easier to set up and monitor, and the card can then be billed directly to the trust.

As with shelter expenses, Arizona’s ALTCS program believes that it can impose additional limitations. ALTCS rules attempt to limit the purchase of a vehicle to a single, handicap-equipped vehicle titled to the trust itself (or titled to a third person with a lien for the purchase price taken back on the vehicle). As with other, similar, limitations, this one is mostly important for self-settled trusts for beneficiaries who are not receiving SSI but are covered by ALTCS.

E. Pre-paid Burial/Funeral Arrangements

Nothing in federal law prohibits or restricts use of special needs trust

funds for burial and funeral arrangements—except that to the extent that the beneficiary owns the arrangements they will be subject to the asset limitations affecting SSI recipients. Once again, Arizona’s ALTCS rules are different—but purchase of pre-paid burial and funeral arrangements is expressly permitted with some limits.

F. Tuition, Books, Tutoring

No limit under either federal or state law. This is an excellent use of special needs trust funds.

G. Travel and Entertainment

Once again, no limit EXCEPT that prepaid airline tickets for foreign travel must be non-refundable (or the beneficiary could convert them to cash), and there may be some concern about payment for hotels (except that when the beneficiary still maintains a residence at home the hotel stay is not really “shelter”) and restaurant expenses. Arizona does impose one limitation on companion travel not found in federal law: ALTCS recipients may not have the special needs trust pay for more than one traveling companion, and that companion must be necessary to provide care, and may not be a person obligated to support the beneficiary (e.g.—a minor beneficiary’s parent).

H. Household Furnishings and Furniture

The trust can be used to purchase appliances, furniture, fixtures and the like. Before March, 2005, there was a theoretical concern that the value of household furnishings might exceed an arbitrary limit and affect the beneficiary’s eligibility; that value limit has now been removed.

I. Durable Medical Equipment

No federal limitation, but once again Arizona takes a more restrictive view for ALTCS beneficiaries. Arizona permits expenditures only for “necessary” medical care, and then argues that ALTCS itself provides all necessary care. In

other words, in the strictest application of the Arizona rule if ALTCS doesn't provide it, the trust can not, either.

J. Care Management

No federal limitation. Arizona's limitation (applying, once again, only to self-settled trusts for ALTCS beneficiaries) is that payments for care or management may not be made to a family member with an obligation of support (e.g.–parents of minor children).

K. Therapy, Medications, Alternative Treatments

Same principle as durable medical equipment, above—so long as the beneficiary is not an ALTCS patient, there is no federal limitation.

L. Taxes

No federal limitation, but Arizona tries to limit payments to taxes incurred as a result of trust assets. Since it is difficult to imagine an SSI, Medicaid or ALTCS beneficiary having significant non-trust income, it is hard to see how this limitation is as troublesome as it is quarrelsome.

M. Legal Fees, Guardianship Fees

Some federal law indicates that payment of guardians' fees or legal fees for guardians may really benefit the guardian and not the beneficiary. Arizona, surprisingly, takes the relatively enlightened view that such payments should be allowed from special needs trusts. Payments for trust administration expenses, including the trust's attorney's fees, are clearly permissible under both federal and Arizona rules.

VI. Trust Administration and Accounting

Actual administration of a special needs trust is in most respects similar to administration of any other trust. A trustee has a general obligation to account to beneficiaries and other interested parties. Tax returns may need to be filed

(though not always), and tax filing requirements will be based on the tax rules, not special needs rules. Some special needs trusts, but by no means all, will be subject to court control

A. Trustee's Duties

As with general trust law requirements, the trustee of a special needs trust has an obligation not to self-deal, not to delegate trustee's duties impermissibly, not to favor either income or remainder beneficiaries over one another, and to invest trust assets prudently. The obligations of a trustee are well-discussed in several centuries of legal precedent, and can not be taken lightly. Legal counsel (and professional investment, tax and accounting assistance) will be required in administration of almost every special needs trust.

A few cardinal trust rules bear special mention:

1. No self-dealing

As with other trusts, the trustee of a special needs trust is prohibited from self-dealing. That means no investment of trust assets in the trustee's business or assets, no mingling of trust and personal assets, no borrowing from the trust, no purchase of goods or services (by the trust) from the trustee (other than, of course, trust administration services), and no sale of trust assets to the trustee. The same strictures also apply to the trustee's immediate family members, and the existence of an appraisal, or the favorable terms of a transaction, do not change these rules.

2. Impartiality

Because the trust has both an "income" beneficiary (the person with disabilities) and a "remainder" beneficiary (the state, in an Arizona payback trust, or the individuals who will receive assets when the income beneficiary dies), the trustee has a necessarily divided loyalty. It is important to remain impartial as between the trust's beneficiaries. Thus,

investment in assets exclusively designed to maximize income at the expense of growth, or vice versa, may violate the trustee's duty to the negatively affected class of beneficiaries. Note that a trust may, by its terms, make clear that the interests of one or the other class of beneficiaries should be paramount—though such language will probably earn the disapproval of the ALTCS overseers in any self-settled trust which must be submitted to ALTCS for approval.

3. Delegation

Generally speaking, a trustee may delegate functions but may not avoid liability by doing so. In other words, while the trustee may hire investment advisers, tax preparers and the like, he or she will remain liable for any failures by such professionals. One important exception: delegating investment authority pursuant to Arizona's version of the Uniform Prudent Investor Act will limit the trustee's liability so that he or she will only be required to carefully select and monitor the investment advisor.

4. Investment

Any trustee should be familiar with the principles of Modern Portfolio Theory, with its emphasis on risk tolerance and asset diversification. A trustee who holds himself, herself or itself out as having special expertise in investments or asset management will be held to a higher standard, but any trustee will be required to understand and implement prudent investment practices.

B. Accounting Requirements

A trustee is required to provide adequate accounting information to beneficiaries of the trust. That requirement generally means annual accountings. While there is no specific form required for accountings, it is important to

provide enough information that a reader could determine the nature and amount of any payment or investment. For some trusts, a simple “check register” accounting may be sufficient, showing interest income and the names, dates and amounts of payees. Any trust with significant assets or diverse investments, however, should provide a thorough accounting.

One important consideration argues in favor of regular, complete accountings. A beneficiary is generally foreclosed from later raising objections to investments or expenditures if he or she received adequate disclosure in the annual accounting at the time. In other words, thorough accounting can limit the trustee’s later exposure to claims by beneficiaries, and therefore benefits the trustee.

C. Reporting to Social Security

The simple term “income” has different meanings in trust accounting, tax preparation and public benefits eligibility determinations. Trustees sometimes raise concerns that thorough trust accountings (to SSI, especially) may result in suspension of benefits, or that tax return information may be used to terminate SSI or other benefits. While such things undoubtedly do occur, Social Security workers are increasingly likely to be relatively sophisticated about such distinctions, and willing to work through any problems. In a general way, then, it is better to disclose more fully to Social Security rather than withhold any information. Annual accountings on any self-settled trust naming an SSI recipient as beneficiary should be provided to Social Security. Any third-party trust which makes significant distributions for the benefit of an SSI recipient should probably be provided to Social Security, just to prevent later problems that could have been headed off. If distributions disrupt eligibility the problem is with the distribution, not with the accounting.

If the beneficiary receives SSDI and not SSI, there is no point in providing

accounting information to Social Security. If the trust is a third-party trust the trustee may not have any obligation to provide accounting information, though the beneficiary may (if trust distributions invoke the ISM rules) be required to do so.

Although it no longer occurs as regularly, some Social Security eligibility workers may misunderstand the effect of special needs trust expenditures or terms and reduce or eliminate benefits improperly. When this does occur it should be possible to remedy the error, but the beneficiary may suffer for months (or years) while the system works out the problem. Far better to head off problems in advance, rather than have to spend substantial resources and time resolving them after the fact.

D. Reporting to Medicaid/AHCCCS/ALTCS

If the trust beneficiary receives SSI and, therefore, is covered by AHCCCS, no separate accounting requirement compels notice to AHCCCS. If, however, the beneficiary of a self-settled special needs trust receives ALTCS benefits, AHCCCS believes that it has the power to impose additional limitations and requires the trustee to not only account to ALTCS but also to complete an annual form detailing anticipated expenditures for the next year (and, incidentally, compels the trustee to sign a statement promising to abide by ALTCS rules AND to provide advance notification before any deviation from the expenditures budgeted at the start of the year). The trustee of a third party special needs trust may not have the same duty to account, but may choose to provide accounting information to ALTCS rather than risk later disqualification of the beneficiary, even though ALTCS' power to consider trust expenditures may be subject to challenge.

E. Reporting to the Court

Many self-settled special needs trusts will be treated in essentially the

same fashion as a conservatorship of the estate. This is so because, typically, the court was initially asked to authorize establishment of the trust; most courts expect any trust established by the court to require annual accountings and setting and maintenance of an appropriate surety bond.

Even if the trust does not require court accounting some consideration should be given to seeking court involvement. One great advantage of court supervision of the trust is that each years' accounting is then final as to all items described in that accounting (provided, of course, that the appropriate notice has been given to beneficiaries who might otherwise complain about the trust's administration).

F. Wrapping up the Trust

If the special needs trust is a self-settled trust with a provision requiring repayment of Medicaid expenses, it will obviously be necessary to determine the "payback" amount upon the death of the beneficiary or termination of the trust. Because the question arises relatively rarely, state agencies may have difficulty providing a reliable final figure. The prudent trustee will request a written statement of the amount due, including evidence showing how it was calculated and a statement of the authority of the author to make the final determination. Once any payback issues have been addressed (and remember that most third party special needs trusts will have no requirement of payment to the state) then termination of the trust will follow the usual requirements of tax preparation and filing, final accounting and distribution according to the trust instrument.

VII. Income Taxation of Special Needs Trusts

Special needs trusts, like other types of trusts, can complicate income tax preparation. The first question to be addressed is whether—for income tax purposes—the trust is a "grantor" trust or not. Tax rules defining "grantor" trusts

are neither simple nor intuitive, but fortunately there are some easy rules of thumb to apply, and they will work for most special needs trusts.

A. “Grantor” Trusts

A “grantor” trust, for tax purposes, is treated as a transparent entity. In other words, the grantor of a “grantor” trust is treated as having received the income directly, even though the accounts are titled to the trust and all income comes in the name of the trust.

Generally speaking, a self-settled special needs trust will be a grantor trust if a family member is the trustee. If the trust names an independent trustee it may still be a grantor trust if one of several specific provisions exists in the trust. A qualified accountant or lawyer should be able to tell whether a given trust is a grantor trust at a glance. If it is, it remains a grantor trust for its entire life—or at least until the death of the grantor (when the trust may either terminate or convert into a non-grantor trust as to its new beneficiaries).

It is generally beneficial for a self-settled special needs trust to be a grantor trust. This is true because the tax rates for non-grantor trusts are tightly compressed, and the highest marginal tax rate on income is reached very quickly for trusts. The practical difference will be small if the trust actually makes distributions for the benefit of the beneficiary in excess of its annual taxable income, but the proper tax reporting approach should still be followed.

1. **Tax ID numbers**

A grantor trust may, but need not, obtain an Employer Identification Number (an EIN). Some attorneys and accountants choose to secure an EIN in each case, while others resist doing so. Although banks, brokerage houses and other financial institutions may insist that the trust requires an EIN, they are simply wrong. There is widespread confusion about the necessity for an EIN for irrevocable trusts, but a confident and well-informed trustee, attorney or accountant should be able to convince the financial institution that it is incorrect.

2. **Filing tax returns**

A grantor trust should not file a separate tax return. If a grantor trust has been assigned an EIN it may file an “informational” return. The return can include a paragraph indicating that the trust is a grantor trust, that all income is being reported on the beneficiary’s individual return, and that no substantive information will be included in the fiduciary income tax return. Actually completing the fiduciary income tax return is not an option for a grantor trust.

B. **Non-Grantor Trusts**

Virtually all third party, and some self-settled, special needs trusts will be non-grantor trusts. Because income will not be treated as having been earned by the beneficiary, a fiduciary income tax return (federal form 1041 and Arizona form 141) will be required.

1. **Tax ID numbers**

A non-grantor trust will need to obtain its own EIN by filing a federal form SS-4. Nearly all third party special needs trusts will be “complex” trusts—this designation simply means that the trust is not required to distribute all its income to the income beneficiary each year.

Although the trust will be listed as “complex” on the SS-4, it may in fact alternate between “complex” and “simple” on each years’ 1041.

2. Filing tax returns

The non-grantor trust must file a 1041/141 each year. All distributions for the benefit of the beneficiary are conclusively presumed to be of income first, so any trust expenditures in excess of deductions will result in a K-1 showing income imputed to the beneficiary. This should not cause particular concern, since Social Security (and even Medicaid) eligibility workers are increasingly likely to understand that “income” for tax purposes is different from “income” for public benefits eligibility purposes. Any tax liability incurred by the individual beneficiary as a result of this imputation can be paid by the trust, though the trustee may not have the authority to prepare and sign the individual’s tax return.