Insight on Estate Planning

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Special needs trusts: Not just for the needy

All in the happy blended family

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Special needs trusts: Not just for the needy

If you have a child or other family member with a disabling condition requiring long-term care or that prevents them (or will prevent them) from being able to support themselves, consider establishing a special needs trust (SNT). Also known as a supplemental needs trust, an SNT allows you to enhance a family member's quality of life without jeopardizing his or her eligibility for government benefits, such as Medicaid or Supplemental Security Income (SSI).

SNT primer

The costs of long-term care for a disabled family member can be enormous and aren't always predictable, and these costs can endanger your family's financial security. An SNT preserves your loved one's access to government benefits that cover health care and other basic needs, provides funds for other important needs, and serves as a safety net against unexpected expenses.

Medicaid and SSI pay for basic medical care, food, clothing and shelter. To qualify for these benefits, however, a person's resources must be limited to no more than $2,000 in "countable assets." Generally, every asset is countable except:

- A principal residence, regardless of value (but if the recipient is in a nursing home or similar facility, he or she must intend and be expected to return to the home),
- A car (which may be subject to value limits),
- A small amount of life insurance,
- Burial plots or prepaid burial contracts, and
- Furniture, clothing, jewelry and certain other personal belongings (which may be subject to value limits).

An SNT is an irrevocable trust designed to supplement, rather than replace, government assistance. Generally, the trust is funded by someone other than the beneficiary, though in certain instances a beneficiary's assets may be used to fund the trust. (See "Dealing with countable assets" on page 3.)

To preserve eligibility for government benefits, the beneficiary can't have access to the funds, and the trust must be prohibited from providing for the beneficiary's "support." That means it can't be used to pay for medical care, food, clothing, shelter or anything else covered by Medicaid or SSI, such as the basic medical care provided by those programs.

With those limitations in mind, an SNT can be used to pay for virtually anything government benefits don't cover, such as unreimbursed medical expenses, education and training, transportation (including wheelchair-accessible vehicles), insurance, computers, and modifications to the beneficiary's home. It can also pay

for “quality-of-life” needs, such as travel, entertainment, recreation and hobbies.

Keep in mind that the trust must not pay any money directly to the disabled individual. Rather, the funds should be distributed directly — on behalf of the beneficiary — to the third parties that provide goods and services to the beneficiary.

Instead of establishing an SNT, some people “disinherit” the disabled family member and leave extra assets to a sibling or other relative who will be responsible for his or her support. This strategy is risky, however, because there’s no legal obligation to use the assets for the disabled person’s care, and the assets may be vulnerable to creditors’ claims.

Careful drafting required

To ensure that an SNT doesn’t disqualify the beneficiary from government benefits, it should prohibit distributions directly to the beneficiary and prohibit the trustee from paying for any support items covered by Medicaid or SSI. Some SNTs specify the types of supplemental expenses the trust should pay; others give the trustee sole discretion over nonsupport items.

Like many trusts, most SNTs contain spendthrift language to protect the trust assets against creditors’ claims. Also, in some states, it may be necessary to include specific language providing that the trust is an SNT, that the funds are intended for only nonsupport purposes and that your intention is to preserve the beneficiary’s eligibility for government benefits. In other states, simply designing the trust as a discretionary trust may be sufficient, but it can’t hurt to include SNT spendthrift language just to be safe.

Dealing with countable assets

What if your disabled family member already owns more than $2,000 in countable assets? An SNT is useless if the beneficiary is otherwise ineligible for government assistance.

Watch out for Crummey powers

It’s common for trusts to include Crummey withdrawal powers to reduce gift taxes. By giving beneficiaries the right to withdraw contributions for a specified period of time after they’re made (30 or 60 days, for example), you can ensure that contributions to the trust constitute gifts of a “present interest” that qualify for the annual gift tax exclusion (currently, $13,000 per recipient; $26,000 for gifts by a married couple).

With an SNT, however, giving the beneficiary the right to withdraw contributions, even temporarily, would probably make the beneficiary ineligible for government benefits. One possible solution to this problem is to name another family member as a remainder beneficiary of the trust and give the Crummey withdrawal powers to him or her.

One solution is a Medicaid payback trust — an irrevocable trust established by the disabled person (or by court order) to pay for permitted supplemental needs during his or her lifetime. When the disabled person dies, any remaining trust assets are used to reimburse the government for Medicaid benefits provided to the beneficiary, with any excess assets going to the trust’s remainder beneficiaries.

Communication is key

If you establish an SNT, communicate your plans to everyone concerned. Otherwise, well-meaning relatives or friends might inadvertently undermine your strategy by making gifts or bequests directly to the special needs person. Let them know that the best way for them to help is to make gifts or bequests to the SNT. ∎

All in the happy blended family

Consider a QTIP trust or ILIT when estate planning for a blended family

No one said estate planning is easy, and this is especially true if you have a blended family. The good news is that there are two trust types — a qualified terminable interest property (QTIP) trust and an irrevocable life insurance trust (ILIT) — that can provide for your children from a previous marriage while also taking care of your current spouse and any children from your current marriage.

QTIP trust

At minimum, you should have a will in place that specifies how your wealth should be distributed. Otherwise, a significant portion of your estate may go to your children from a previous marriage — even if they're now adults and don't need the assets as much as your current spouse and children. If your children from a previous marriage are minors, your former spouse could end up with control of the assets — something you simply may not want to happen.

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To implement your wishes for wealth distribution, you may find it helpful to establish a QTIP trust, one of the most effective estate planning tools available for blended families.

A QTIP trust qualifies for the estate tax marital deduction, meaning that assets you transfer to the trust aren't taxed when you die, and the entire amount is available for your spouse's support. (Note that, if your spouse isn't a U.S. citizen, he or she must take additional steps to shield the assets from taxes.) But unlike an ordinary marital trust, a QTIP trust can provide your spouse with income for life while preserving the principal for your children (from either your current or previous marriage, or from both) or other beneficiaries.

When your spouse dies, though, the trust assets will be subject to tax as part of his or her estate, even if the assets are to pass to your children as instructed in your will. If the value of your spouse's estate is greater than the lifetime exemption amount (currently $3.5 million), the balance could be subject to hefty estate taxes.

ILIT

In some cases — particularly when one spouse is considerably younger than the other — a QTIP trust may not be the best solution. That's because the children from a first marriage, who may be much older than those from the second marriage, may have to wait years until the younger spouse dies and they can receive their inheritance.

In situations like this, an ILIT may be a better solution. The ILIT purchases life insurance on the older spouse, who makes annual exclusion gifts to the trust to cover the premiums. If the ILIT is designed properly, there won't be any estate tax on the insurance proceeds.

When the older spouse dies, the trust collects the death benefit and pays it out to the children from the first marriage. The older children receive their inheritance immediately, and the other assets remain available to provide for the younger spouse and children.

Besides allowing you to achieve a fair and balanced estate plan, life insurance can augment your estate, helping to ensure that there's enough wealth to go around. But keep in mind that, depending on how you and your spouse set up your estate plans, if one of your taxable estates exceeds the estate tax exemption, some of your younger children's inheritance could be lost to estate tax. Careful planning for both spouses is critical.

Also think twice before transferring an *existing* insurance policy to an ILIT — if the insured spouse doesn't survive for at least three years after the gift, the proceeds of the policy will be included in his or her estate (assuming the transfer was a taxable gift).

Discuss your plans

Before choosing any estate planning approach, discuss your plans with your loved ones. Even if your plan is inherently fair, it may not be perceived that way without an explanation. In addition, consider the consequences of different wealth transfer strategies. QTIP trusts and ILITs are only two of the many tools available to control the distribution of your wealth in a way that minimizes taxes and maximizes benefits for everyone involved.

Now's the time to revisit your buy-sell agreement

If you own an interest in a closely held business, it's a good idea to review your buy-sell agreement, particularly its valuation provisions. The economic crisis has been tough on everyone, and many business owners have seen the value of their shares decline. If a buy-sell agreement's terms don't reflect current conditions, your interest may be priced too high.

A buy-sell agreement that overvalues your interest can result in higher estate taxes and hurt the business or its surviving owners.

Buy-sell benefits

Buy-sell agreements permit or require the company or the surviving owners to buy back the interest of an owner who dies, becomes disabled or otherwise leaves the business. Their benefits include:

- Restricting ownership to family members, management or some other select group,
- Creating a market for otherwise unmarketable shares,
- Providing an owner's family with cash to pay estate taxes and other expenses, and
- Establishing the value of the interest for gift and estate tax purposes (if certain requirements are met).

A buy-sell agreement's valuation provision specifies the price — or, more likely, the method for determining the price — that will be paid for a departing owner's interest. The most effective valuation method is to conduct regular, independent appraisals of the business interests. This helps ensure that the price is fair and that it accurately reflects the value of the business at the time the interest is transferred.

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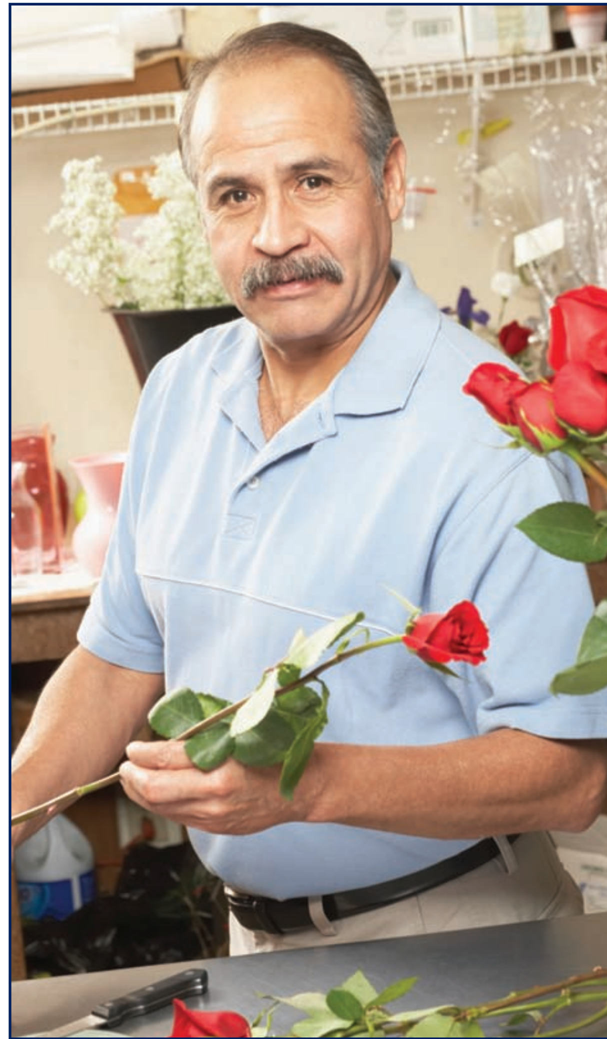
Valuation formulas: Handle with care

Some companies set the buy-sell price using a formula — such as book value or a multiple of earnings or cash flow. Well-designed formulas can provide an effective low-cost alternative to periodic appraisals, but they also present some risks.



For a family business, for example, to use a formula to establish an interest's value for gift and estate tax purposes, you must prove that the buy-sell agreement is a bona fide business arrangement and that its terms are comparable to similar arrangements entered into by unrelated parties. Failure to meet IRS requirements can lead to a determination that the interest was undervalued, resulting in additional taxes, interest and penalties.

During good economic times, formulas based on book value often underestimate business value because they don't reflect current fair market value, and they fail to consider earnings or goodwill. But even formulas based on earnings or cash-flow multiples are risky. Why? Because multiples are derived from industry averages that may not fully reflect the characteristics of the business being valued.

In today's volatile economic times, valuation formulas may be even more dangerous. The values of some businesses have dropped below their book values. And earnings or cash flow may no longer be reliable indicators of fair market value. What may have in the past been an appropriate formula may no longer be relevant. For instance, perhaps 10 years ago six times earnings before interest and taxes (EBIT) was a good indicator of value for companies in a particular industry. But if four or five times EBIT is more accurate today, the formula should be adjusted.

Evaluate your agreement

To determine whether your buy-sell agreement is still doing its job, evaluate its valuation provision to ensure that it yields a fair price. If your agreement uses a formula, consider switching to periodic appraisals. But if you continue to use a formula, review it to be sure it reflects current conditions in your industry and in the economy as a whole. ▮

Estate Planning Pitfall

You plan to take a retirement distribution later this year

If you're over the age of 70½ — or if you reach that age this year — you may be planning to take required minimum distributions (RMDs) from your IRA, 401(k) plan or other retirement accounts later this year. But you may be better off taking advantage of a tax law change that lets you skip RMDs this year.

Leaving funds in your tax-deferred accounts as long as possible often can make sense from an estate planning perspective. The longer you allow your retirement funds to grow on a tax-deferred basis, potentially the more there will be for your heirs.

Normally you must take your first distribution by April 1 following the year you turn 70½. After that, annual distributions are required no later than Dec. 31. Many people take their first RMD *during* the year they turn 70½ to avoid taking two distributions the following year.

In the economic downturn, the value of many investments has declined, so it's not the best time to make withdrawals from tax-deferred accounts. Lawmakers recognized this when they enacted the Worker, Retiree and Employer Recovery Act of 2008 late last year. The act suspended RMDs for 2009.

If you reached age 70½ before this year, you can skip the distribution that would have been required by Dec. 31, 2009. And if you turn 70½ during 2009, you can skip your first RMD — which would have been due by April 1, 2010 — so you won't have to take an RMD until the end of 2010.

The act also provides relief for people with inherited retirement accounts. The rules are a bit complicated, though, so if you're in that situation, consult your estate tax advisor to find out whether you're entitled to skip this year's RMD.

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