Types of Special Needs Trusts

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Last month's article discussed the concept and utility of special needs trusts – a type of trust that is commonly used to benefit disabled persons who are receiving (or may in the future receive) mean-tested public benefits. **Here we will review the different types of special needs trusts.**

The different types of trusts share certain common features but at the same time differ in important respects. For example, the need for a purely discretionary standard for making distributions is common to all types of special needs trusts. However, whether persons other than a disabled individual can also benefit and exactly who can serve as trustee depends upon the particular type of trust involved.

Third Party Special Needs Trusts

The type of special needs trust previously discussed was a third party special needs trust (also sometimes called a "common law special needs trust"). This type of trust is typically associated with advanced planning for a disabled beneficiary's future needs.

As the name suggests, a third party special needs trust is one that is created and funded by persons other than the disabled beneficiary. The settlor (creator) can in theory be anyone other than the beneficiary. However, as a practical matter, the person creating the trust is most often going to be a disabled beneficiary's parent or grandparent.

Because the disabled family member is not the source of funding for the trust, the disabled family member need not be the only beneficiary during their lifetime. Although it is somewhat less common, third party trusts can be structured to simultaneously benefit a disabled family member and one or more other members of the family.

Also, there is considerable flexibility with regard to trustee selection. The sole restriction is that the disabled family member cannot serve as the trustee. Otherwise, the trustee can be whomever the settlor selects. Yet another advantage of a third party trust is that there is generally no required payback of means-tested public assistance benefits when the beneficiary dies. Any funds remaining in the trust after the beneficiary dies can be paid to whomever the settlor designates.

Self-Settled Special Needs Trusts

A self-settled special needs trust (also called a “statutory” special needs trust) is one in which the disabled beneficiary’s own assets are used to fund the trust. These types of trusts are most often utilized when a disabled individual unexpectedly receives money or property that would otherwise disqualify them from receiving one or more means tested public benefits.

For example, a disabled beneficiary might unexpectedly obtain money through a lawsuit (such as personal injury action) or through an inheritance that was not properly planned. In order to remain eligible for such benefits, the disabled individual must divest themselves of the assets that they unexpectedly received.

A self-settled trust is a tool that can be used to accomplish that objective for two reasons:

1. Transfers to the trust are “exempt” and therefore do not affect the beneficiary’s eligibility; and
2. Assets held by the trust are considered “unavailable” to the beneficiary.

There are two different major sub-categories of self-settled special needs trusts: a “payback” trust and a “pooled” trust.

Payback Trust

A payback trust in most respects resembles what one would envision when they hears about a “trust”: The party administering the trust assets (the trustee) can be whomever the settlor selects (so long as it is not the disabled beneficiary), and the assets that the beneficiary transfers to the trust are physically segregated and constitute the sole assets of the trust. However, because the payback trust is funded with the disabled beneficiary’s own assets, certain additional requirements apply.

The first such requirement is that the disabled individual must be the sole beneficiary of the trust during their lifetime. If any other persons directly or indirectly benefit from the trust during the beneficiary’s lifetime, the trust assets will be considered “available” to the beneficiary and will likely disqualify them from receiving resource-limited government benefits.

The second requirement is that, when the disabled beneficiary dies, the government must be reimbursed for all medical assistance paid throughout the beneficiary’s entire lifetime before any other persons are permitted to receive any portion of the remaining trust assets.

A payback trust will generally make more sense when the money or other assets received by the beneficiary is substantial and the beneficiary’s age, health or other factors make it unlikely that the entire amount remaining in the trust will be utilized before the disabled beneficiary dies.

Pooled Trust

A pooled trust is another type of special needs trust funded with the disabled beneficiary’s own assets. As with the payback trust, transfers to the trust are exempt and the trust assets are considered outside of the beneficiary’s control and therefore are not counted toward the beneficiary’s eligibility for public benefits.

A “pooled” trust arrangement is one in which the beneficiary’s assets are contributed to a pre-existing trust established by a nonprofit organization and “pooled” with assets contributed by other disabled beneficiaries. Each beneficiary’s assets are separately tracked and reported but the contributed funds are administered as a common fund for investment purposes. The nonprofit organization serves as trustee of the trust. So unlike a payback trust, there is no choice in trustee selection, and thus a family member cannot manage or control the entrusted funds. When the disabled beneficiary dies, any unused funds typically remain in the pooled trust to benefit similarly affected beneficiaries.

Because the pooled trust is a preexisting trust, there is no need to prepare a trust agreement. The beneficiary instead signs a much simpler “joinder” agreement – essentially, an agreement that the assets contributed by the beneficiary to the trust will be administered in the same manner already specified in the trust’s preexisting trust agreement.

The principal advantages of the pooled trust are simplicity, ease of administration and the expertise of the nonprofit trustee in administering such trusts. The main disadvantage is that money remaining in the trust when the beneficiary dies cannot be used for other family members.

The pooled trust will typically be more appealing when it’s unlikely that significant funds will remain in the trust when the beneficiary dies. That will often be the case if the amount of funds contributed by the disabled beneficiary are relatively small or when the beneficiary’s age or health dictate that most or all of the trust funds will be used during the beneficiary’s lifetime.

See also: Special Needs Trusts: What, Why, When and What Else?

If you have questions about special needs trusts or have other Elder Law or Estate Planning concerns, please contact one of our Elder Law Attorneys or call 814-459-2800.

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