

Funding a Special Needs Trust

Diversified Brokerage Services, Inc.

The greatest concern for parents of a child with special needs is not knowing what will happen when they are no longer able to care for the child because of their own health issues or, more critically, after their deaths.

While there may be an abundance of love in the family, there may not be adequate financial assets to maintain the lifestyle that the parents desire for their child. Even for families with significant assets now, the future is unknown and special needs may last the child's lifetime. As parents grow older, their own aging and health care issues may consume a greater portion of their assets than anticipated, thus impacting the care that can be provided to the child.

Although public assistance programs such as Social Security and Medicaid are designed to provide only some very basic medical care and possibly shelter for disabled persons, they are an important aspect of the financial care of the child with special needs. These programs are often needs based and never provide more than the basics. They do not provide the child the "pleasures of life," such as vacations, recreation, education, job training, rehabilitation, computer equipment, transportation, and so forth. Those items and others must all be funded from other sources, and those funds may be more difficult to obtain as parents grow older. Because public programs are needs based, it is important that funding be provided in a manner that does not impute income or assets to the child in any way that would jeopardize those benefits. The objective of special needs planning is to provide for a standard of living that is higher than basic subsistence while preventing a loss of government benefits. A **special needs trust** is often used for that purpose. Your tax and legal advisors can help you determine if this type of trust is right for your situation.

A special needs trust is a trust that will provide for financial management of family gifts, inheritances, and life insurance proceeds in order to provide a child with special needs the comforts of life and other necessities not provided by funding from governmental agencies.

Typically, the parents or other family members establish such a trust. The person who establishes the trust is called the grantor. A trustee, who can be anyone other than the child with special needs, manages the assets. Typically, the parents serve as trustees. Because a trustee has full and absolute discretion on whether or not to provide financial assistance, the existence of the trust, if properly drafted, avoids being counted as an asset by various other programs, thus protecting public benefits.

Obviously, in order for the trust to accomplish its purpose, it must be funded. How the trust is funded will depend upon whether the trust is a revocable trust, an irrevocable trust, or a testamentary trust.

Revocable Trust

A revocable trust can be funded as soon as it is created, and additional money or assets can be placed in it at any time by anyone. If the parents choose to establish a revocable trust as the special needs trust and serve as the trustees, they maintain control of it in all respects. That control, however, comes at a price. During the life of the grantor, the trust is not a separate taxpayer. All of the income, dividends, and capital gains generated by the trust assets are taxed to the grantor, not the trust. If the grantor's estate is large enough to be subject to estate taxation, the trust assets are also subject to that tax. The assets in a revocable trust are also subject to the grantor's creditors.

The good news is that the parents may place assets into the trust without limitation as to amount or type. Others may also make gifts to the trust. Those gifts may or may not be subject to gift tax, depending on the size of the gift. Often, it is a grandparent who desires to put assets into the revocable trust established by the parents. This causes at least two problems. The gift from the grandparents is now in the parents' revocable trust, and any assets placed in that trust are included in the parents' estates for estate tax purposes, as well as being subject to the claims that any creditors might have against the parents. Secondly, a distribution from the trust will be considered a gift to the child, thus potentially doubling the gift transaction.

The trust can also be the recipient of inheritances from friends and family and can be the owner and beneficiary of a life insurance policy. Since the trust is revocable, the parents (assuming that they are the grantors) can withdraw assets from it from time to time for themselves, the child, or other family members.

Irrevocable Trust

An irrevocable trust is also established during the parents' lifetimes. Because the trust is irrevocable, the parents lose a measure of control, but there are reasons that they might be willing to do so. This type of trust pays its own income tax so items of income are not included on the parents' income tax return. Only the creditors of the trust can reach its assets; the trust is not subject to the claims of the parents' creditors. However, the most common reason for using an irrevocable trust is as an owner and beneficiary of life insurance in order to avoid the inclusion of the insurance proceeds (as well as other trust assets) in the parent's estate for estate tax purposes.

A disadvantage of the irrevocable trust is the difficulty in funding it during the lifetimes of the grantors. Because it has a separate existence from the parents, any money that they or anyone else place into it is a gift. Because the child

cannot withdraw assets from the trust at the time of the gift, the gift likely will not qualify for the annual per donee gift tax exclusion. That means that there may be gift tax consequences involved in funding an irrevocable trust. The receipt of the insurance proceeds by the trust at the death of the insured generally is subject to neither gift nor estate taxation, and life insurance death benefits are generally received income tax-free under IRC § 101(a). Thus an irrevocable trust coupled with life insurance is one of the best ways to help provide significant funding for the future of the child. This strategy does not take into account the time value of money and may not be appropriate in all cases.

Testamentary Trust

Because the terms of a testamentary trust are contained in a will, this type of trust cannot come into existence until the death of the maker of the will (testator). The disadvantage of using a testamentary trust is that it cannot be funded as long as the testator is alive. It can be funded only after death, for example, by life insurance proceeds, an inheritance, or as the result of receiving assets as a beneficiary of an IRA.

Funding the Trust

As noted, each of these trusts has its own funding advantages and disadvantages; however, regardless of which type of trust is used, the amount of money or other assets that most families have available to place in trust for the child, either during life or at death, is limited. Unless there are substantial assets available from the family, it is very difficult to sufficiently fund the trust to provide care for the lifetime of the child.

It is important to carefully consider all options that are available and ensure that they are used wisely. Lifetime planning with a legal advisor who specializes in special needs planning is critical. The family must know what public assistance is available and understand that changes in those programs may occur, and that those changes may negatively impact the

availability of funds even after the parents' deaths. Events within the family such as retirement, disability or the deaths of those providing the funding will likely disrupt the lifestyle of the child. Unfortunately, the parents' ability to provide funding later in life is generally reduced.

In many cases, the parents are able to address the child's needs while they are alive. However, a parent's untimely death could cause considerable financial hardship not only for the child but also for other family members. And this is where a licensed financial professional and The Prudential Insurance Company of America can be of assistance.

Life Insurance

Life insurance can be the most cost effective and efficient method for providing funding to help achieve family goals. It immediately places assets in the trust at the deaths of the parents or other insureds.

The value of life insurance for special needs families goes beyond simply providing for the child. An untimely death of the breadwinner in the family could significantly impact the financial situation of all of the family members, not just that of the child with special needs. Therefore, it is important to consider not only providing funding for the child but also the surviving spouse and other family members. Working with your tax and legal advisors, we can help put in place the funding to help ensure the financial future of your family.

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