A Survey of Operational Issues Affecting Supplemental Needs Trusts: Impact of the Who and Why of a Distribution

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In the first article, published in the Summer 2016 *Journal*, we discussed the impact of the Income Tax rules on the administration of a SNT. This article will explore how the purpose of the distribution and to whom it is made affects means-tested government benefits. The treatment of trust distributions to a disabled beneficiary for federal income tax purposes is much different from the treatment of those same distributions for purposes of eligibility for means-tested government benefits. Balancing the income tax consequences with the needs and desires of the disabled beneficiary of an SNT (while maintaining eligibility for means-tested programs) is one of the most complex and important tasks left to the trustee.

We've learned that there is much incentive on the part of the trustee of a SNT to make current distributions of income to the disabled beneficiary. The difference in the income tax brackets of an individual and a trust almost compels distributions to the disabled beneficiary to avoid the heavy income tax burden imposed on the SNT. If the Trustee of a SNT makes an income distribution during the tax year, the amount of the distribution reduces the amount of the SNT's income subject to a federal income tax by a like amount. For income tax purposes, a Trustee is indifferent as to the purpose of the distribution or to whom or how a distribution is made. In essence, a "distribution" is a "distribution" for purposes of the "income distribution deduction" afforded the SNT to reduce its taxable income.

However, federal income tax brackets are not the only factor the Trustee must consider when making distributions from the SNT. Other rules, specifically those related to eligibility for means-tested benefits, dictate that distributions from a SNT must be made solely "for the benefit of" the beneficiary, never for food or shelter, and never directly to the beneficiary. In the exercise of the Trustee's discretion, there should be no distributions which jeopardize the amount of the beneficiary's means-tested government benefits or his/her eligibility for those benefits. In other words, *why, how* and *to whom* the distribution is made or used is as important as *that* the distribution was made.

Example #1

Distributions from a SNT to pay a $96 monthly cable bill will most generally carry with it $1,152 of "income" annually to generate an "income distribution deduction" and thereby reduce the SNT's taxable income. If the $96.00 is paid directly to the beneficiary, the SNT receives an income distribution deduction. Since it was paid directly to the beneficiary it is considered "income" for purposes of Medicaid and SSI and will thereby reduce his/her benefits. If, on the other hand, if the trustee paid the cable company directly the distribution would still result in an income distribution deduction for income tax purposes. Since the $96 payment is going to a third party for a service which is not considered food or shelter, it is disregarded in determining the beneficiary's 'income" for purposes of eligibility for Medicaid or SSI.

The Program Operations Manual System (POMS)[1] advises Social Security case workers to consider a trust established for the "sole benefit" of an individual only if it benefits no one but that person with a disability, whether at the time the trust is established or at any time for the remainder of the individual's life. Except for several specific exceptions to the general rule, the POMS advise that a *first party* trust which provides for the trust corpus or income to be paid to or for any person other than the SSI applicant/recipient is not established for the sole benefit of the individual. POMS § SI01120.201.F.2.b. (applying to first party SNT's and not third-party SNTs) provide three exceptions to the general rule prohibiting payments to third parties:

1. Payments to a third party that result in the receipt of goods or services by the disabled beneficiary.
2. Payment of third party travel expenses which are necessary in order for the disabled beneficiary to obtain medical treatment.
3. Payment of third party travel expenses to visit a trust beneficiary who resides in an institution, nursing home, or other long-term care facility; *provided that* the travel is for the purpose of ensuring the safety and/or medical well-being of the disabled beneficiary.

The exceptions to the general rule articulated in the POMS are very narrow; some may say unnecessarily narrow. For example, the POMS suggest that it is impermissible to pay the way of a companion to accompany an individual with a developmental disability to an entertainment venue or on vacation, no matter how compelling. The limits of these three exceptions caused an uproar in the community of those who administer SNTs and their professional advisors. A number of professional associations have engaged in dialogue with the Social Security Administration to broaden the exception.

The disabled beneficiary of an SNT is materially affected by: "*to whom*" the distribution is paid and by the" *purpose*" of the distribution. The first rule which must be followed by a trustee of any SNT is: *never* distribute cash or its equivalent directly to the disabled beneficiary, but *always* make the distribution solely for the benefit of the beneficiary.

Example #2

A trustee of a SNT cannot purchase for or make a gift to a friend or relative of the disabled beneficiary, nor can it make distributions to satisfy the disabled beneficiary's support obligation for minor children. Certainly, the amount used for the gift or support obligation will be considered a distribution from the SNT for income tax purposes. However, if the trustee does make a distribution for these purposes, the trustee will jeopardize the status of the trust as a "supplemental needs trust" and the beneficiary's eligibility for means-tested government benefits. Supplemental needs trusts are defined as "solely" for the benefit of the disabled beneficiary. Distributions wholly or partially for the benefit of a third party are strictly prohibited.

Example #3

Any distribution from a SNT directly to the disabled beneficiary will be considered "unearned" income. For purposes of SSI benefits, the first $20 of "unearned" income received in a month is not counted. However; there is a dollar for dollar reduction in SSI benefits for any unearned income received in a month in excess of the $20 disregard. A $130 cash distribution from SNT intended to allow the disabled beneficiary to purchase video games will result in a $110 reduction in subsequent month's SSI benefits. In essence, the beneficiary is *worse* off financially than if the distribution were not made at all! If, instead, the SNT purchased the video games directly from the retail provider, the disabled beneficiary has the video games *without* any reduction of his/her SSI benefits.

Any distribution by an SNT for food or shelter will affect the disabled beneficiary's SSI benefits. Such distributions are called "in-kind support and maintenance" (ISM). As noted in the previous example, payment of cash to the disabled beneficiary for food or shelter (such as "rent money" or "spending money") will result in a dollar-for-dollar reduction of SSI benefits after the $20 disregard. The reduction in SSI benefits also applies to payments directly to vendors of food or shelter (such as a landlord, grocery store or restaurant). The reduction in benefits for payments to vendors is equal to the *lesser of*: (i) the actual amount of the payment to the vendor for the item of food or shelter; and (ii) one-third of the amount of the federal portion of the Beneficiary's monthly SSI benefit, plus $20 (the PMV). The federal portion of the monthly SSI benefit in 2016 is $733. New York augments the federal contribution to the SSI benefit with its own amount by an additional amount of $87. (A total SSI benefit for eligible New Yorkers is $820). The PMV for 2026 is $266.

The Social Security Administration (SSA) considers only the following "household costs" as amounts paid for "food" and "shelter": (i) food; (ii) mortgage (including property insurance required by the mortgage holder); (iii) real property taxes (less any tax rebate/credit); (iv) rent; (v) heating fuel; (vi) gas; (vii) electricity; (viii) water; (ix) sewer; and (x) garbage removal. Condominium fees in themselves are not household costs. However, condominium fees may include charges which are household costs (*e.g.*, garbage removal). When planning distributions from the SNT, the trustee must consider the purchases from vendors which *are not* included as household costs; strive to pay for those items; and leave the disabled beneficiary to pay only for household costs from his/her SSI benefits. Nevertheless, the tradeoffs to providing some ISM are worth the benefit which accrues to the disabled Beneficiary.

Example #4

A disabled beneficiary would have a very difficult time finding an apartment in Brooklyn with SSI as his/her sole source of income. Assume a "decent" one-bedroom apartment is $1,750/month. Even if he/she devoted the entire monthly SSI benefit to rent, the disabled beneficiary could not afford the apartment. While payment of rent to the landlord of the disabled beneficiary is considered a household cost, the maximum reduction in his/her monthly SSI benefits is only $266: the PMV. Thus, the disabled beneficiary can live in a "decent" apartment and still have $554/month for other essentials. The reduction of monthly benefits is acceptable, especially since it places the recipient in an apartment he/she could not otherwise afford.

Example #5

Not everything purchased at a grocery or department store is considered a household cost. "Food" does not include toiletries, paper products, tobacco products, small or large appliances, cleaning supplies or furnishings. An enterprising trustee of an SNT can find a way to make those purchases directly from the store without affecting the disabled beneficiary's SSI benefits. The trustee can secure a credit card (conventional or prepaid) for use by the disabled beneficiary's caretaker to purchase those items not considered a household cost. The trustee can pay the credit card issuer directly for the costs of the purchases and which will provide the trustee documentation that the SNT distribution was for the "sole" benefit of the disabled beneficiary.

Example #6

Not every recurring expense of a disabled beneficiary is considered a household cost. The cost of a landline or cellular phone service and the cost of cable and internet access are not considered as an item of "shelter." An enterprising trustee could contract directly with the phone, cable or internet provider to allow the disabled beneficiary service and pay the monthly bill directly to the company. This would provide a life enhancing service and leave the SSI benefits available for other "essentials."

While the amount of the purchase of services does not present any special difficulties, the Trustee of an SNT must consider carefully the impact of a purchase of any real or tangible personal property. If the property purchased is *not* an "exempt resource," its value must be kept under $2,000 for SSI benefits purposes. While the fact *that* the distribution was made has a tax impact on the SNT itself, the *purpose* of the distribution will have a significant impact on the disabled beneficiary's quality of life. If made for the proper purpose it will enhance the beneficiary's life; if not, it may disqualify him/her from means-tested government benefits.

Exempt resources include (among others): (i) the disabled beneficiary's home; (ii) a vehicle used for transportation, of any value; (iii) burial plot; (iv) household goods and personal effects, of any value.

1. Home:
   Is property in which an individual has an ownership interest and that serves as his or her principal place of residence. It can include: (i) the shelter in which he or she lives; (ii) the land on which the shelter is located; and (iii) related buildings on such land. An individual's principal place of residence is the dwelling the individual considers his or her established or principal home and to which, if absent, he or she intends to return. It can be real or personal property, fixed or mobile, and located on land or water; for example, a "fifth wheeler" or house boat may be considered a home.

2. Pre-paid Burial Contract:
   A prepaid (or pre-need) burial contract is an agreement whereby the buyer pays in advance for a burial that the seller agrees to furnish upon the death of the buyer or other designated individual. If a burial contract cannot be revoked and cannot be sold without significant hardship, it is not a resource. However; any portion of the contract that represents burial funds reduces the $1,500 maximum otherwise available for the burial funds exclusion; but any portion that represents the purchase of burial spaces has no effect on the burial funds exclusion.

3. Vehicle:
   A vehicle includes any car, truck , motorcycle, boat, animal drawn vehicles, even an animal, of any value which is used by the disabled beneficiary for transportation. It does not include vehicles used for recreation, such as a boat used for fishing on the weekends.

4. Household Goods:
   Items of personal property, found in or near the home, the householder uses on a regular basis. The householder needs household goods for maintenance, use, and occupancy of the premises as a home. Examples of household goods include (i) furniture; (ii) appliances; (iii) electronic equipment such as computers and televisions; (iv) carpets; (v) cooking and eating utensils; and (vi) tableware and dishes.

5. Personal Effects:
   Items of personal property ordinarily worn or carried by the individual, or items that have an intimate relation to the individual. Examples of personal effects include (i) personal jewelry, including wedding and engagement rings; (ii) personal care items and clothing; (iii) pets, such as a cat, dog, hamster, horse, monkey, or snake; (iv) educational or recreational items, such as books, musical instruments, or hobby materials; or (v) items of cultural or religious significance to an individual, such as ceremonial attire.

Example #7

While the purchase of a vehicle by the SNT will result in the acquisition of an "exempt resource," care must be taken that the disabled beneficiary can and does use the vehicle for transportation. If it is not actually used for transportation, but another purpose (such as recreation) its value must be less than $2,000 or the disabled beneficiary will lose his/her eligibility for SSI until his/her "countable resources" are reduced to below the $2,000 threshold. The exemption is for *one* vehicle and the value of other property owned by the beneficiary must be considered for the $2,000 resource limit.

Example #8

The exemption for household goods and personal effects leaves wide latitude to the trustee of a SNT to purchase goods which enhance the disabled beneficiary's quality of life. If there is enough in the SNT, there is nothing to stop the trustee from furnishing the beneficiary's home or apartment; from purchasing electronic gear for computing or gaming; from purchasing music, CDs, a televisions and a stereo. The trustee must be aware that the SNT is for the "sole" benefit of the disabled beneficiary, so roommates should be expected to contribute their "fair share" of the expense of any item purchased for common use.

While any distribution from an SNT will allow an income distribution deduction to reduce or eliminate the federal income tax at the trust level, the *purpose* to which that distribution is made will determine whether that same income is sheltered from federal income tax at the beneficiary level. One of the most useful and most likely deduction afforded an individual taxpayer is the medical expense deduction allowed under Code §213(a). Generally, an individual can deduct only the part of his/her medical and dental expenses that exceeds 10% of adjusted gross income ("AGI"). The medical expense deduction includes: (i) insurance premiums for medical and dental care; (ii) prescription medicines or insulin; (iii) acupuncturists, chiropractors, dentists, eye doctors, medical doctors, occupational therapists, osteopathic doctors, physical therapists, podiatrists, psychiatrists, psychoanalysts (medical care only), and psychologists; (iv) medical examinations, X-ray and laboratory services: (v) diagnostic tests; (vi) nursing care; (vi) hospital care (including meals and lodging); (vii) clinic costs; and (viii) lab fees. A disabled beneficiary's income is generally very low since he/she must meet the income limitations for means-tested government benefits (*i.e.*, under approximately $1,130/month to avoid a total disqualification from SSDI benefits). Accordingly, the 10% of AGI limitation is not an insurmountable obstacle to the disabled beneficiary; especially since many doctors, drugs and therapies are not covered by public health insurance benefits. Nevertheless, distributions from a SNT carry with them taxable income. If the purpose of the distribution from the SNT is to pay for drugs, medical services or devices not otherwise covered by private or public health insurance, the disabled beneficiary may be able to take a medical expense deduction to reduce his/her taxable income.

Example #9

In 2016, the disabled beneficiary had $20,000 of uncovered expenses for prescription drugs, doctors who did not take Medicaid, and acupuncture. The SNT paid the costs of these medical expenses on behalf of the disabled beneficiary. In addition the SNT made distributions on his behalf of the disabled beneficiary of all of its other income in the trust for cell phone and cable service, many CDs, a computer and computer games in the amount of $4,050. The Beneficiary received a $820 monthly SSI benefit and had no other income.

a) As a result, the beneficiary's AGI is $24,050 and he/she is entitled to deduct $17,600 of his medical expenses [$20,000-($24,050x.10) = $17,650], and has a $4,050 personal exemption amount. This results in taxable income of $2,350 which is taxed at a 10% bracket under the Code. A $235 federal income tax is due (an effective tax rate of 10%). The SNT does not owe a federal income tax.

b) If under the facts set forth above the disabled beneficiary did not have the $20,000 in uncovered medical expenses, his/her taxable income would be $13,650 [$24,000-($4,050 personal exemption + $6,300 standard deduction)]; and he/she would owe a federal income tax of $1,586.25 (6.6% effective tax rate). The SNT would not owe a federal income tax.

Endnotes

1. The Program Operations Manual System ("POMS") is a body of written regulations which is used by the field agents of the Social Security Administration to determine eligibility for and the amount of SSI paid to an individual with a disability.

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