When is an Irrevocable Special Needs Trust Revocable?

By
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A Special Needs Trust (SNT) is a trust that is used to manage property for the benefit of a disabled individual. A SNT is a third party created SNTs when it is funded with the assets of a third party for the benefit of a disabled person. A SNT is a self created SNT when it is funded with the disabled person's assets. If properly created and administered, a SNT has several desirable effects for a disabled person who is receiving Supplemental Security Income (SSI) or Medicaid benefits.[2] First, the funding of the trust will not result in a period of ineligibility for these government benefits. Second, the trust is not a countable resource for eligibility purposes. However, the Social Security Administration (SSA) has recently used the used the property law Doctrines of Worthier Title and Merger to disqualify trusts that are designed to be self created SNTs.

In 1993 Congress amended the Medicaid rules relating to trusts. This amendment, frequently referred to as OBRA 93, included 42 USC §1396p(d)(4)(A) which provides for the creation of a self created SNT known as (d)(4)(A) SNT. The amendment provides that the assets of a disabled person may be transferred to a (d)(4)(A) SNT for the benefit of the disabled person. The transfer does not result in a period of ineligibility for Medicaid long-term care services, and the trust is not a resource for Medicaid eligibility purposes.

42 USC 1396p(d)(4)(A) defines a (d)(4)(A) SNT as a trust that contains the assets of an individual under age 65 who is disabled as defined in the Social Security Act and is established for the sole benefit of the disabled individual by a parent, grandparent, legal guardian of the individual, or a court, and the trust agreement must provide that the state will receive all amounts remaining in the trust upon the death of the disabled individual up to an amount equal to the total medical assistance paid on behalf of the disabled individual under a state Medicaid plan.

The Foster Care Independence Act of 1999[3] amended the SSI rules to reestablish the transfer of assets penalty for SSI and provided an exception from these rules for (d)(4)(A) SNTs. Since many disabled persons qualify for Medicaid medical assistance benefits based on SSI eligibility, it is frequently imperative to comply with the SSI rules.[4]

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[2]The Section 8 Housing program does not provide similar benefits for d(4)(A) SNTs.

[3]Pub. L. No. 106-169, § 206 (enacted Dec. 14, 1999).

[4]See Advising the Elderly or Disabled Client by Frolik and Brown, published by RIA for a discussion of the Medicaid and SSI eligibility rules and benefits.

The SSA publishes the Program Operations Manual (POMS) as its operating instructions for processing Social Security claims. Although these instructions are not the product of formal rule making, the Supreme Court has held that the POMS "warrant respect."[5] The SSA has issued POMS[6] that advise its Claims Representatives (CR) how to evaluate (d)(4)(A) SNTs. The POMS impose seven criteria to determine if a (d)(4)(A) SNT is valid, including the requirement that the (d)(4)(A) SNT be irrevocable.[7] The most frequent reason that the SSA determines that a (d)(4)(A) SNT is invalid, and therefore a countable resource for SSI eligibility purposes, is that the trust is revocable.[8] The CR is instructed to consult regional and national SSA instructions to determine if the trust is revocable or irrevocable. Therefore, drafters of (d)(4)(A) SNTs should include a provision in the trust agreement that the trust is irrevocable. Is this enough to satisfy the SSA requirement that the trust be irrevocable? The answer is not always.

The SSA has relied upon the Doctrine of Worthier Title (DWT) and the Doctrine of Merger to hold that a trust which expressly states that it is irrevocable is in fact revocable, and therefore a countable resource. Two recent examples of this position are the decisions in *Smiarowski v. Commissioner*[9] and *Thompson v. Barnhart*.[10] In the Smiarowski decision the 11th Circuit Court of Appeals upheld the decision of the SSA that a court created d(4)(A) SNT for a disabled minor was revocable dispite the fact the trust agreement expressly stated the trust was irrevocable. The trust agreement upon the minor's death directed the repayment of the state's Medicaid payments, granted the minor a special power of appointment upon the remaining trust assets, and provided that the minor's heirs were the default residuary beneficiaries. The court upheld the SSA's decision that the special power of appointment did not create a remainder interest and the DWT nullified the remainder interest in the disabled minor's heirs. Therefore the disabled beneficiary was the sole beneficiary and grantor of the trust and the trust was revocable under state law. In the Thompson decision, the federal Disctrict Court for Vermont upheld the decision of the SSA that a (d)(4)(A) SNT[11] was in fact revocable

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[5]Washington State v. Keffeler, 537 U.S. 371 (2/25/2003).

[6]SSA POMS SI 01120.202. You can find the SSA POMS on the SSA website, www.ssa.gov, in the Our Program Rules section.

[7]The other requirements are that (1) the trust must be established with the assets of the disabled beneficiary, (2) who is under the age of 65, (3) who is disabled within the meaning of the social security act, (4) for the sole benefit of such disabled beneficiary, (5) by a parent, grandparent, legal guardian or a court, and (6) upon the beneficiary's death, the state must be reimbursed by for all Medicaid expenditures for the disabled beneficiary.

[8]Of the 18 Regional Counsel Opinions published in the POMS concerning the treatment of trusts as countable resources, the sole reason for disqualification of trusts was the issue of irrecovability. See POMS PS 01825 Trusts.

[9]United States Court of Appeals, 11th Circuit, D.C. Docket No. 01-14167-CV-NCR, November 14, 2002.

[10]D. Vt., No. 2-02-CV-141, July 17, 2003

[11]Once again the trust agreement expressly stated the trust was irrevocable.

because the DWT invalidated the purported remainder interest and vested a reversionary interest in the grantor. Since the grantor held a life estate and at death held a reversionary interest, the grantor held the sole beneficial interest in the trust.[12] The court reached this conclusion although West Virginia (the applicable governing law for the trust) had abolished the DWT as a rule of law. The court held that West Virginia would retain the DWT as a rule of construction.

When this trend was reported by David Lillesand, a Miami, Florida, disability attorney, at the 2002 Stetson Law School Special Needs Trust Conference, many of the attendees did not remember the DWT or confused it with the Rule in Shelley's Case. [13]

What is the DWT? Under the common law DWT, an inter vivos conveyance that includes a remainder interest to the grantor's heirs results in an automatic reversion and nullifies the attempted gift of a remainder to the grantor's heirs.[14] Because many (d)(4)(A) SNTs are created by courts for incapacitated persons, courts frequently insist that the trust agreement name the disabled person's heirs as the remainder beneficiary.[15]

What is the Doctrine of Merger? Where same person holds both a life estate and a vested reversion, without an intermediate estate, the reversion at once merges into the life estate.[16] If the DWT nullifies the attempted remainder interest, under the Doctrine of Merger the disabled person

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[12]The Restatement of Law, Second, Trusts, §339 states: "If the settlor is the sole beneficiary of a trust and is not under an incapacity, he can compel the termination of the trust, although the purposes of the trust have not been accomplished... The rule stated in this Section is applicable although the settlor does not reserve a power of revocation, and even though it is provided in specific words by the terms of the trust that the trust shall be irrevocable." Despite the fact that the Restatement requires that the settlor not be under an incapacity, the 11th Circuit Court of Appeals upheld the SSA's decision that a disabled minor who was the grantor and sole beneficiary could revoke the trust. The court held that state law permitted a guardian to act on the child's behalf. We believe the 11th Circuit was in error on this matter, since this holding would have the effect of deleting the requirement that the grantor and beneficiary not be under an incapacity.

[13]What is the relationship of the DWT to the rule in Shelley's Case? These two rules of law are different and distinct. The common law rule in Shelley's Case states that where a life estate is conveyed to A and in the same instrument a remainder is granted to A's heirs, the purported transfer of the remainder is not recognized and A takes the ownership of the entire property. The Rule in Shelley's Case is not applicable to (d)(4)(A) SNTs since the disabled grantor of the trust retains a life estate rather than convey it to a third party.

[14]28 Am. Jur. 2nd, Estates §199.

[15]See In re Rosenbaum Trust, 2003-Ohio-1830 (Ohio Ct. App. April 10, 2003).

[16]See Michie's Jurisprudence, Merger, §4. For the Doctrine of Merger to apply, the two estates should be: 1) held by the same person, 2) at the same time, and 3) in one and the same right.

for whom the trust was created is the sole beneficiary.

What is the effect of the Merger? Under the laws of many states, a trust that is created by a grantor solely for the grantor's benefit is revocable even if the trust terms make it irrevocable.[17]

Is the DWT a rule of law or a rule of construction? Where the DWT is a rule of law, it must be applied to the construction of a (d)(4)(A) SNT, and the grantor's intent is irrelevant. In some states, the DWT has been abolished as a rule of law.[18] While the DWT was originally a rule of law, it is now generally considered to be a rule of construction rather than law.[19] The courts will normally give effect to the intention of the parties. Where the DWT is a rule of construction, the DWT will not undo the grantor's expressed, specific intent to make a gift of a remainder to those who will be his or her heirs. The Restatement of Law, Third, Trusts `does not recognize the DWT or the rule in Shelley's Case either as a rule of law or also a rule of construction.[20] In other states, the DWT has been made inapplicable to d(4)(A) SNTs.[21] The draftsperson of a (d)(4)(A) SNT must determine whether the DWT is a rule of law, a rule of construction or has been abolished as both a rule of law and construction in the drafters state.

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[17]See foot note 12.

[18]For example, see W.Va. Code §36-1-14a which provides: " Wherever a person, by conveyance inter vivos or by will, purports to create any present or future interest in real or personal property in a class of persons described as his own heirs, next of kin, distributees, or by other words of like import, such heirs, next of kin or other described persons shall take, by purchase and not by descent or distribution, the interest so purported to be created; it being the intent and purpose of this section to completely abolish the rule of law known as the doctrine of worthier title and the rule of law that a grantor cannot create a limitation in favor of his own heirs or next of kin. This section shall only apply to instruments which become effective after the effective date of this section."

[19]28 Am. Jur. 2nd Estates §201; Braswellv. Braswell v. Madison, 195 Va. 971 (1954); and Doctor v. Hughes, 225 N.Y. 305 (1919).

[20]Restatement of Law, Trusts, Third, §49: "At early common law there were rules of law, known as the doctrine of worthier title and the rule in Shelley's Case, that essentially prohibited the creation of a remainder interest in land in the heirs of a grantor (treating that interest as a reversionary interest) and the creation of a remainder in the heirs of another following a freehold interest in that other person (treating the remainder as belonging instead to that person and often resulting in a beneficial interest in fee simple). Over time, these rules were narrowed in application or softened into rules of construction. They have now been abolished by legislation or rejected as a part of the common law in nearly all jurisdictions. No such rules of law or construction are recognized by this Restatement."

[21]For example, New Jersey statute N.J.S. 3B:11-37 f provides that "Notwithstanding any provision or principal of law to the contrary, a beneficiary, grantor, trustee or other personal shall not have authority to revoke an OBRA 93 trust. This provision shall apply whether or not the OBRA 93 trust instrument designates the trust as irrevocable or whether the OBRA 93 trust was created by a court or otherwise."

What is the SSA's position on the DWT? At the fall 2003 meeting of the Special Needs Alliance[22] (SNA), Ken Brown of the SSA's national SSI policy group stated that the SSA does not have a set position on the DWT. It follows applicable state law. Five regional offices of the SSA[23] have issued regional POMS concerning applicable state law on the DWT for its Claims Representatives (CR). Drafters of d(4)(A) SNTs must be familiar with these these regional POMS. Mr. Brown anticipated that the SSA may issue formal regulations on (d)(4)(A) SNTs in 2004.

What should you do if the SSA challenges an existing d(4)(A) SNT based on the DWT? You should argue that under the applicable state law the DWT is a rule of construction and not a rule of law. As a rule of construction, the DWT will not be applied if the Grantor's intended to create a remainder interest in his or her heirs. This position was successful in Lanoue V. Commissioner.[24] If the Grantor's intent is unclear, you should argue that under the Restatement of Law, Second, Trusts, §33, the settlor and sole beneficiary has the power to revoke the trust only if he or she is not under an incapacity. Since the grantor and beneficiary of a d(4)(A) SNT is a disabled person within the meaning of the Social Security Act, he or she is likely to be incapacitated under state law. If so, he or she should not have the power to revoke the trust.

How should the drafter of a d(4)(A) SNT respond to the use of the DWT by the SSA?

- If the DWT is a rule of law under the applicable state law, then the trust could vest a $10 remainder interest in a named beneficiary prior to giving the grantor's heirs the remaining trust assets.[25] This approach is called the $10 solution.

- An alternative to the $10, solution, the trust could vest a one day income interest in a named

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[22]The Special Needs Alliance is a national alliance of disability attorneys, www.specialneedsalliance.com.

[23]Atlanta, Boston, Chicago, Dallas and New York SSA Regional Offices. These regional POMS provide a summary of the laws of 29 states on the DWT. Unfortunately, the regional POMS are not always current on DWT issues. The New York office regional POMS on the DWT, SI NY01120.200 last updated on September 25, 2001, does not incorporate N.J.S. 3b:11-37 f which was enacted in 2000. This code section states that a (d)(4)(A) SNT is irrevocable notwithstanding other legal doctrines to the contrary.

[24]The New Hampshire Supreme Court, 774 A.2d 1236 (N.H. 2001), on referral from the US District Court in Lanoue V. Commissioner held that the DWT was a rule of construction to determine the grantor's intent. If the grantor's intent was to create an irrevocable trust, then the courts should honor the intent. As a result the District Court found that the SSI benefits would continue since the trust was irrevocable.

[25]For example, Mr. David Lillesand, a Miami, Florida disability attorney, recommends the following provision: "on death, repay Medicaid, then pay the sum of $10 to Jane Doe, and distribute the balance, to my heirs ...."

charity[26], before naming the grantor's heirs as the remainder beneficiaries.[27] This technique may be perceived as a safer alternative than the $10 solution since it vests a remainder interest in the entire trust property rather than potentially creating a $10 claim on the trust. This approach is called the one day solution.

- If the DWT is a rule of construction under applicable state law, then the trust could expressly state the grantor's intent to make a gift of a remainder to those who will be his or her heirs.[28] This approach is called the statement of intent.

- The trust agreement could expressly name specific persons as the remainder beneficiaries rather than the grantor's heirs.[29]

- In all cases, the trust agreement should expressly state that the trust is irrevocable.

At the SNA meeting Mr. Brown stated in his opinion that both the $10 solution and the statement of intent should work.

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[26]We recommend using a named charity rather than a named individual beneficiary. Individuals may do unpredictable things that could cause a problem. There is less risk using a named charity.

[27]This technique was suggested by Rodney Johnson, Professor Emeritus of Law, University of Richmond School of Law. For example, the trust agreement could state: "on death, repay Medicaid, then pay the net income of the trust to a named charity for one day, and then distribute the remaining trust assets, to my heirs ...." If the DWT is a rule of law, this approach will not prevent it from applying. The remainder intended for the heirs will still be void and the grantor will have a reversion. However, the imposition of the one-day vested remainder in the designated charity, between the Grantor's life estate and Grantor's reversion, should prevent the merger of the two interests. Another safer alternative is to give the remainder to "charity for one day and, then, one day after charity's estate has terminated, to those persons who wold have been Grantor's heirs if Grantor had died at that time (i.e., two days following Grantor's actual date of death), or, if no such persons exist, to charity in fee simple." This alterative strategy is twofold: (1) Because of the one-day gap between the termination of the charity's interest and the beginning of that in the "heirs," the interest of the latter is a springing executory limitation and not a remainder; and (2) Because the takers of the interest are to be determined based upon facts that exist two days after the Grantor's death, these takers cannot be Grantor's heirs as, by definition, "heirs" are determined based upon the facts that exist at the Grantors' death. Thus, as what the Grantor is disposing of is not a "remainder," and as it is not being given to Grantor's "heirs," there is no opportunity for the common law DWT to apply, because is requires a "remainder to the Grantor's heirs."

[28]This technique was also suggested by Prof. Rodney Johnson. For example the trust agreement could state: "The grantor intends to make a gift at his death of the remainder interest in this trust to his or her heirs. The Doctrine of Worthier shall not be used to construe this trust."

[29]The SSA takes the position that the state under the mandatory payback provision is a creditor of the trust and not a remainder beneficiary.

What do we recommend when drafting a d(4)(A) SNT? We recommend a suspenders and belt approach that incorporates into the trust both (1) the $10 or one day solution and (2) the statement of intent. Where possible, we also recommend that the trust agreement expressly name the remainder beneficiaries rather than make a gift to the grantor's heirs. In all cases, the trust should state the grantor's intent that the trust is irrevocable.[30]

[30]The Spring 2004 supplement to Representing the Elderly or Disabled Client written by us and published by RIA will contain a (d)(4)(A) SNT with all three suggested solutions to the DWT problem.