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The Fiduciary Pitfalls of Managing Special Needs Trusts That Own Real Estate
By Marielle F. Hazen, CELA, and Shirley B. Whitenack, Esq., CAP

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By Marielle F. Hazen, CELA, and Shirley B. Whitenack, Esq., CAP

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About the Authors

Marielle F. Hazen, CELA, is the founder of Hazen Law Group in Harrisburg, Pennsylvania, a firm dedicated to the practice of elder law and special needs planning, estate planning, tax planning, and estate administration. She is a past president and one of the founding members of the Pennsylvania Chapter of the National Academy of Elder Law Attorneys (NAELA), Pennsylvania Association of Elder Law Attorneys (PAELA). She is a past chair of the Elder Law Section of the Pennsylvania Bar Association. Ms. Hazen is a past president and member of the Board of Directors of the Special Needs Alliance. She participates on NAELA's Grassroots Advocacy Committee. She is actively involved in the legislative advocacy activities of PAELA, the PBA Elder Law Section, the Special Needs Alliance, and NAELA.

Shirley B. Whitenack, Esq., CAP, is a partner at Schenck, Price, Smith & King, LLP with offices in Florham Park and Paramus, New Jersey. Ms. Whitenack devotes a substantial portion of her practice to trust and estate litigation and elder law and special needs planning. Ms. Whitenack is a Fellow of the National Academy of Elder Law Attorneys (NAELA), is a NAELA past president, and is a member of NAELA's Council of Advanced Practitioners (CAP).

I. Introduction

There are many reasons a trustee may hold real estate in a special needs trust (SNT), but there are also many pitfalls a trustee must be aware of to avoid liability and protect the interests of the trust beneficiary. With the limited housing options available for individuals with disabilities, a home purchased by an SNT may be the option that best meets the trust beneficiary's housing needs. The trust also may hold nonresident real property for investment purposes or perhaps a partial interest in real estate used as a family vacation home or for a family business. In any of these situations, the trustee must carefully manage the real estate to protect the interests of the beneficiary and to limit liability for the trustee. Litigation against trustee fiduciaries is a fast-growing area of law, and trustees of SNTs can be especially vulnerable. Trustees must be cognizant of their powers, duties, and responsibilities in administering trust property not only to protect the interests of the trust beneficiary but also to protect themselves against this increased exposure to liability. This article analyzes the challenges and risks trustees of SNTs must consider before holding real property in a trust.

II. Considerations in Owning and Titling Real Property in Special Needs Trusts

Trustees of SNTs often are confronted with requests from beneficiaries, guardians, conservators, and family members to purchase a home for the beneficiary with trust funds. Those who acquiesce, however, frequently rue that decision. While home ownership may make sense at first blush, many problems can and do ensue. The more expensive the home is, the more expensive the upkeep. Home ownership can prove to be a gigantic headache for the trustee, and many professional trustees have had bad experiences when a trust owns a home. Trustees must consider many factors when deciding whether to purchase real property.

A. Budget Considerations

Finding affordable, accessible housing can be a significant challenge for disabled individuals. When considering whether to purchase a home for the trust beneficiary, the SNT trustee must evaluate the trust funds available for the purchase, project future expenses involved in maintaining the property, and consider the life expectancy of the trust beneficiary. This analysis involves developing a budget for the purchase amount, necessary improvements to accommodate the beneficiary's needs, and ongoing maintenance and upkeep. Retaining the services of a life care planner may be very helpful in conducting this analysis.

B. Trust Ownership Versus Beneficiary Ownership

If the trustee determines that the purchase and maintenance of a home for the trust beneficiary is affordable and sustainable, the trustee must determine whether title to the property will be held by the trust or by the trust beneficiary individually. If a trust is going to purchase a home, it is important that the trust document authorize both the acquisition and maintenance of a residence. Otherwise the purchase may be an inappropriate fiduciary investment. If the trust is a third-party SNT, and the purchase of a residence is an allowable distribution according to the terms of the trust, the trustee could purchase the home and title it in the name of the trust beneficiary individually. If the trust is a self-settled trust, in some states, titling the home in the name of the trust

beneficiary individually is not allowable. In other states, this may be an option, but the state Medicaid agency may need to receive notice of the purchase. Additionally, a self-settled trust cannot be used to satisfy legal obligations of a third party, and parents have a legal obligation to provide shelter for minor children.[1] If the trust beneficiary is a minor, this must be taken into consideration.

If titling the residence in the beneficiary's name is desirable, but adequate resources are not available to the beneficiary for the purchase, the SNT trustee could loan money to the beneficiary to purchase a home. The loan, however, should be secured by a mortgage. The loan may include interest or be interest-free, and the loan payments may be deferred until the beneficiary's interest in the home is transferred either by sale or by death of the beneficiary. If the trust is subject to a Medicaid payback provision, the loan repayment is subject to payback.

III. Special Needs Trust Beneficiary Owning Property Outright

A. Beneficiary Control

A number of advantages exist if the beneficiary owns the property outright, including control and independence for the beneficiary. Also, beneficiary ownership insulates the trust and trustee from liability related to maintenance and upkeep of the property as well as from liability to third parties for injuries incurred on the property.

If an individual has been adjudicated an incapacitated person and a guardian of the estate or conservator has been appointed, property held by the trust beneficiary is controlled by the guardian or conservator for the benefit of the trust beneficiary. Guardianships and conservatorships are governed by state law, and in many states, court approval must be obtained for any real property transactions.[2]

B. Payback Avoidance

If the trust is to be funded from a personal injury settlement or award, or if the beneficiary's assets are otherwise ample, it may be prudent to purchase the home using the settlement or award proceeds or the beneficiary's assets instead of the SNT. Because the home is the trust beneficiary's principal place of residence, it is considered an exempt asset for determining his or her eligibility for Medicaid and Supplemental Security Income (SSI).[3] In the case of self-settled trusts, the home is not subject to the trust's payback provision if the beneficiary owns the home outright. For beneficiaries 55 years of age or older, however, depending on the state where they live, the property may still be subject to estate recovery.[4] The Medicaid program directs states to recover the costs of the medical assistance paid on behalf of persons age 55 or older for nursing facility services, home and community-based services, and related hospital and prescription drug services.[5] State law determines which assets are subject to recovery.[6]

1 *See Hobbs v. Zimmerman*, 579 F.3d 1171, 1176–1177 (10th Cir. 2009).

2 A. Kimberley Dayton et al., *Advising the Elderly Client* § 34:42 (Thomson Reuters 2015); *see e.g.* 20 Pa. Consol. Stat. § 302 (enacted 1992, current through 2016); *see also* e.g. Pa. Orphan's Ct. R. 14.4.

3 42 U.S.C. § 1382b (2012); *see also* Social Security Program Operations Manual System (POMS) SI 01130.100(B)(1) (Nov. 13, 2013).

4 42 U.S.C. § 1396p(b)(4).

5 42 U.S.C. § 1396p(b)(1)(B).

6 42 U.S.C. § 1396p(b)(4).

C. Avoidance of Sole Benefit Rules

Another potential benefit of outright ownership by the trust beneficiary is that the property will not be subject to the sole benefit rules; therefore, depending on the terms of the trust, other family members may be able to live in the home without being required to pay rent. This may be an advantage in some cases, and in others, payment of rent by family members residing in the property may be appropriate and in the best interest of the beneficiary.

D. Tax Treatment of Gain on Sale

Upon the sale of the property, if there is a capital gain, the beneficiary is able to exclude up to $250,000 if single, and $500,000 if married, provided the ownership and residency requirements are met.[7] If the trust is owned by a self-settled trust, this same exemption is available, but if the trust is owned by a third-party SNT, there is no exclusion for the gain. This is because the exclusion is only available if the taxpayer is considered an owner under the grantor trust rules.[8]

E. Disadvantages

There are a number of disadvantages of outright home ownership by the trust beneficiary. The beneficiary may not be mentally, emotionally, or physically able to maintain the home. If the beneficiary sells the home and has net proceeds that are not invested in another residence, the proceeds may disqualify the beneficiary from public benefits such as SSI and Medicaid unless the proceeds are placed in a self-settled SNT. Any rental payments made by family members residing in the property are considered income for the beneficiary, which may impact the beneficiary's eligibility for public benefit programs. For beneficiaries with poor credit histories, it may be difficult to obtain adequate insurance coverage for the property and the home will be subject to the beneficiary's creditors; therefore, a financially irresponsible beneficiary could put the home at risk. Additionally, the beneficiary could mortgage the home, fail to pay necessary expenses such as taxes and insurance, or allow the property to fall into disrepair.

IV. Special Needs Trust Property Ownership

An alternative is for the trust to own the property. This gives the trustee control over the asset to protect it for the benefit of the trust beneficiary and provides protection from creditors and from the trust beneficiary's temptation to overspend or borrow against the property. For married beneficiaries, the trust offers protection in the event of divorce. Additionally, if a tenant moves into the property to share in the household expenses, the rental income becomes income of the trust rather than the trust beneficiary. Consequently, any profit is not considered countable income for determining the trust beneficiary's eligibility for public benefits.

The disadvantages are significant if the trust owns the property, however, and the trustee should seriously consider the potential pitfalls before purchasing real estate. Many financial institutions and other corporate and professional trustees decline to serve as trustees of an SNT that owns a home because they have had negative experiences as trustees of such trusts. Additionally, corporate fiduciaries that require a minimum asset level to initially fund the SNT may not include the value of the home in calculating whether the minimum asset level has been met. Despite the potential pitfalls, real property

7 26 U.S.C. § 121 (2012).

8 Rev. Rul. 85-45, 1985-1 C.B. 183.

can be successfully managed in an SNT if the trustee is aware of the special considerations inherent in doing so and takes care to properly address them.

A. Public Benefit Considerations

Before an SNT purchases a residence for the trust beneficiary, the trustee must carefully review the potential impact of the purchase on the public benefits of the trust beneficiary. An SNT trustee has a responsibility to administer the trust in a way that preserves and maximizes the trust beneficiary's eligibility for public benefits. Failing to do so exposes the trustee to liability for breach of his or her fiduciary duty. Some of the factors that should be considered when evaluating the impact on public benefits eligibility are as follows.

1. Supplemental Security Income Rules

For SSI purposes, an individual's home, regardless of value, is an excluded resource.[9] It is excluded so long as it remains the recipient's residence, or so long as the recipient subjectively intends to return to it.[10] Homes owned by trusts that are considered resources under SSI rules are eligible for the same exclusion.[11] If the trustee of a trust that is not considered a resource for SSI purposes purchases and holds title to a property as a home for the beneficiary, the beneficiary is considered to have an equitable ownership interest in the home and the home is not considered a resource for the beneficiary. The home also is not considered a resource if the beneficiary moves out.

In-kind support and maintenance (ISM) is food or shelter provided to the SSI beneficiary by someone else, including food or shelter provided by a special needs trust.[12] An eligible individual does not receive ISM in the form of rent-free shelter while living in a home in which he or she has an ownership interest. Accordingly, an individual with an equitable home interest under a trust is not receiving rent-free shelter while residing in a residence owned by the trust.[13]

Even if the home is not considered a resource for the beneficiary, if the trust purchases the home outright and the beneficiary lives in the home during the month of purchase, the purchase is considered ISM for the beneficiary during that month. Likewise, if the trust purchases the home with a mortgage, in the month of purchase and each month thereafter when a mortgage payment is made, if the beneficiary lives in the home, the payments are considered ISM for the beneficiary.[14]

ISM can reduce SSI benefits in a couple of ways. One is through the One-Third Reduction rule, or value of the one-third reduction (VTR) rule, which applies when the SSI recipient resides in someone else's household and receives both food and shelter from others living in the household.[15] In these cases, the Social Security Administration (SSA) reduces the SSI recipient's monthly benefit to two-thirds of the maximum federal benefit rate.

A second way ISM can reduce SSI benefits is through the Presumed Maximum

9 42 U.S.C. § 1382b; *see also* POMS SI 01130.100(B)(1) (Nov. 13, 2013).

10 20 C.F.R. § 416.1212(a), (c) (2016); *see also* POMS SI 01130.100 (Nov. 13, 2013)

11 POMS SI 01120.200 (Dec. 11, 2013).

12 42 U.S.C. § 1382a(a)(2)(A); 20 C.F.R. § 416.1130; *see also* POMS SI 00835.000 (Dec. 11, 2014).

13 42 U.S.C. § 1382a(a)(2)(A); *see also* POMS SI 00835.000 (Dec. 11, 2014), 001120.200F (Feb. 7, 2013).

14 POMS SI 01120.200(F)(3)(b) (Feb. 7, 2013).

15 20 C.F.R. § 416.1131; *see also* POMS SI 00835.200 (Nov. 13, 2013).

Value (PMV) rule, which applies when the VTR rule does not apply.[16] PMV applies when the SSI recipient owns his or her own home. As outlined above, an SSI recipient residing in a home owned by an excluded trust is considered to have an equitable ownership interest in the home. Therefore, any ISM is subject to the PMV rule, which presumes that the value of ISM received is one-third of the maximum federal benefit rate plus a $20 disregard.[17] For example, if an SNT pays the household expenses for an SSI recipient, the SSA presumes that the value of ISM is one-third of the maximum federal benefit rate plus $20. In 2016, the PMV was one-third of $733 plus $20, or $264.33.[18] Unlike VTR, PMV is a rebuttable presumption.

Under SSI rules, ISM is any food or shelter given to the beneficiary. "Shelter includes room, rent, mortgage payments, real property taxes, heating fuel, gas, electricity, water, sewerage, and garbage collection services."[19] Therefore, if the SNT pays the beneficiary's shelter expenses for the month, the trust is providing ISM to the beneficiary. The effect of ISM on the beneficiary's SSI eligibility is that the SSA will presume that the shelter expenses paid during the month are worth one-third of the SSI payment the beneficiary would otherwise be entitled to receive. The beneficiary can attempt to rebut this presumption by proving that the value of the shelter received is less than the presumed value, but in many cases, the shelter expenses paid by the trust exceed one-third of the SSI payment.

Condominium fees in themselves are not household costs.[20] However, condominium fees may include charges that are household costs (e.g., garbage removal). Only property insurance required by the mortgage holder in order to receive the mortgage is considered a household cost. Insurance (property, fire, theft, etc.) held at the owner's or renter's option is not a household cost.[21]

Even though it may appear beneficial to pay hundreds or even several thousands of dollars a month for a beneficiary's shelter while only reducing his or her SSI benefit by one-third of the SSI payment the beneficiary otherwise would receive, ISM can be added to other income the beneficiary receives and may result in SSI disqualification. ISM payments should be made only after fully considering all other income the beneficiary receives.

2. Medicaid Rules

Ownership of a residence outright by the beneficiary or in an SNT does not interfere with Medicaid eligibility because the primary residence is considered an exempt resource.[22] However, there are important considerations related to the Medicaid program, which vary somewhat among states because Medicaid is a joint federal and state benefit program. If a property owned outright by the beneficiary is sold, the proceeds may interfere with the beneficiary's continued eligibility for benefits. Additionally, as mentioned in

16 20 C.F.R. § 416.1140; *see also* POMS SI 00835.300 (June 14, 2012).

17 20 C.F.R. § 416.1140; *see also* POMS SI 00835.300 (June 14, 2012).

18 20 C.F.R. § 416.1140(a); *see also* Soc. Sec. Administration, *Cost-of-Living Increase and Other Determinations for 2016*, Docket SSA-2015-0063-0001 (Oct. 30, 2015).

19 20 C.F.R. § 416.1130(b); POMS SI 00835.465 (Nov. 7, 2013).

20 POMS SI 00835.465(D) (Nov. 7, 2013).

21 POMS SI 00835.465(D)(3) (Nov. 7, 2013).

22 20 C.F.R. § 416.1212(a), (c); POMS SI 01130.100 (Nov. 13, 2013).

Section III, depending on the state where the Medicaid recipient resides, the property may be subject to an estate recovery claim after the recipient dies. The Medicaid program allows states to place a lien against property owned by a Medicaid recipient age 55 or older in order to recover the costs of nursing facility or home and community-based services provided to the recipient.[23]

When the residence is owned by a self-settled trust, the state Medicaid agency has an interest in how the trust is administered because of the aforementioned required payback provision.[24] State Medicaid agencies have different procedures and requirements related to self-settled trusts holding interests in real property. Some require notice before a trust invests in real property. Most determine whether the trust is in compliance with the sole benefit considerations discussed earlier in this article. Some states require periodic accountings or notice before certain principal expenditures are made. Failure to comply with state and federal Medicaid rules may result in the trust assets being considered resources for determining the beneficiary's eligibility for benefits.[25]

B. Duties and Responsibilities Unique to Trustees of Special Needs Trusts That Own Real Estate

1. Distinguishing First-Party and Third-Party Trusts

Additional duties and responsibilities are unique to trustees of SNTs. These vary somewhat depending on the type of SNT involved. Third-party SNTs are established under state law and are created and funded by someone other than the trust beneficiary.[26] They do not have to be for the sole benefit of the trust beneficiary, but rather may have multiple beneficiaries. Allowable distributions are defined by the trust terms and any state law limitations, but for the trust to be disregarded for purposes of eligibility for public benefits including SSI and Medicaid, distributions must be discretionary for the trustee.[27]

First-party, also called self-settled or (d)(4)(A), SNTs are similar to third-party SNTs in that they also benefit trust beneficiaries with special needs by allowing them to retain supplemental resources while still qualifying for public benefits. Self-settled SNTs, which are established under federal and state law,[28] must:

1. Be created by a parent, grandparent, legal guardian, competent individual with disabilities; or court;
2. Be funded with the trust beneficiary's assets;
3. Be irrevocable;
4. Be created before the trust beneficiary turns 65, and the trust terms must prohibit additional transfers to the trust after the trust beneficiary turns 65; and
5. Include a provision providing for the repayment, after the trust beneficiary's death, of Medicaid benefits paid on behalf of the trust beneficiary.

Self-settled trusts are "intended to provide disabled individuals with necessities and comforts not covered by Medicaid"[29] while allowing such individuals to maintain eligibility for public benefits.

23 42 U.S.C § 1396p(b)(1)(B).

24 42 U.S.C § 1396p(d)(4)(A).

25 POMS SI 01120.203 (Feb. 7, 2013).

26 POMS SI 01120.200(B)(17) (Dec. 11, 2013).

27 POMS SI 01120.200(D) (Dec. 11, 2013)

28 42 U.S.C § 1396p(d)(4)(A); *see also* state enabling legislation, *e.g.* 62 Pa. Stat. § 1414 (2005).

29 *Lewis v. Alexander*, 685 F.3d 325, 333 (3d Cir. 2012), *cert. denied*; 133 S. Ct. 933, 184 L. Ed. 2d 724 (2013).

2. Adherence to Sole Benefit Rules

Self-settled trusts must be administered for the sole benefit of the trust beneficiary; therefore, any other family members living in the home may need to pay their pro rata share of household expenses. If the trust was created pursuant to 42 U.S.C. § 1396p(d)(4)(A), the trust assets must be used for the sole benefit of the beneficiary, but the sole benefit rules can be murky, especially when dealing with real property held in an SNT.

When the SNT beneficiary is unable to live independently or is a minor, family members may reside with the beneficiary. If the beneficiary is a minor, the parents generally have a legal support obligation that must be considered. The family members may be unemployed or also have disabilities. Even if they are employed, the family members may believe that they are entitled to benefit from the trust. Some parents, for example, may forego asserting their own claims in a medical malpractice lawsuit, believing that all of the money should fund their child's SNT. But they also may believe that they are entitled to compensation from the trust because they provide a substantial amount of care. In some cases, especially those in which family members provide extraordinary care and forego employment to provide this care, it may be possible to determine the value of the caregiving services and enter into an arrangement whereby the services the family members provide offset their required contribution toward household expenses.

The law governing SNTs may require others living in the home to contribute a pro rata share of household expenses. For example, New Jersey's regulations governing self-settled SNTs states:

> For example, if the trust acquires housing for the benefit of the trust beneficiary, and other family members also live in that house, the trust document shall provide that the trustee shall require and collect a pro rata contribution for the expenses of uses incurred, and shall return such contribution to the trust. Such collections shall be reflected in the annual required trust accounting.[30]

Therefore, if both parents and one other child are living in the home owned by the trust, the trust can pay only 25 percent of the costs.

The murkiness of this issue was highlighted in the recent North Carolina case of *In Re: Estate of Skinner*.[31] Cathleen Bass Skinner was the beneficiary of a self-settled SNT, and her husband was the trustee. As trustee, her husband used trust assets to purchase a home that became his and Cathleen's primary residence. Extended family members challenged his actions, arguing that he violated the sole benefit rules. The court disagreed, holding:

> Based upon a review of the regulatory definitions and the common law principles of trust law, the reasonable interpretation of the "sole benefit" rule for a U.S.C. § 1396p(d)(4)(A) trust is that:
>
> 1. The trust must have no primary beneficiaries other than the disabled person for whom it is established.
> 2. The trust may not be used to effect uncompensated transfers or other sham transactions. For example, the sole benefit provision would be violated if the beneficiary's parents funded the trust with the assets of the beneficiary and then had the beneficiary give the money to her parents in a sham transaction.
> 3. The trust is one in which the trustee does not have a duty to balance the fiduciary benefit to the beneficiary with a duty to ensure that funds remain for creditors such as Medicaid or for contingent beneficiaries.

30 N.J. Admin. Code 10:71-4.11(g)1ii(1)(A).

31 787 S.E.2d 440 (N.C. App. 2016).

4. When trust assets are used for investments, the financial and legal benefit of these transactions must remain with the trust.

In this case, Mrs. Skinner is the only primary Beneficiary named in the Trust. The house purchased with Trust assets is titled in the name of the Trust. (Mrs. Skinner would be considered to be living in her own house based on her equitable ownership of the residence.) The accrual of equity in the house or increase in the house's market value remains with the Trust, and thus is for Mrs. Skinner's legal benefit. The use of Trust assets to purchase a house, furniture, and appliances for Mrs. Skinner was an expenditure that resulted in her receiving goods. We conclude that the Cathleen Bass Skinner Special Needs Trust was established, and is being administered, for Mrs. Skinner's sole benefit. We have reached this conclusion without consideration of any aspect of this case that might implicate the weight or credibility of evidence, such as Mr. Skinner's testimony that Mrs. Skinner's parents wanted her to have a house. Instead, we have based our conclusion solely upon the undisputed terms of the Trust and the applicable jurisprudence.[32]

Contrast this case with the opinion rendered in *Est. of Jerome Silverstein*,[33] which also involved real estate owned by an SNT. The trust beneficiary lived in the property along with other immediate family members, and the court held that the trustee breached the fiduciary duty to the trust beneficiary by allowing these immediate family members to occupy the property without paying either fair market rent or their pro rata share of the household expenses.[34]

Even if the governing law does not require a pro rata contribution by other occupants, the court may order that the others contribute their pro rata share. This means the trustee is charged with collecting the payments from the other family members who may be unable or who simply may refuse to pay their pro rata share. The beneficiary's eligibility for Medicaid and SSI benefits may be jeopardized because of a sole benefit rule violation. The failure to obtain pro rata contributions may constitute an impermissible transfer of assets.

The trustee may seek approval from the court or the state Medicaid agency in such instances so that the trust is not found to be in contravention of the sole benefit rule. The court, however, may not have the authority to make such a determination. In the N.J. Superior Court Appellate Division case of *In re: A.N.*,[35] the co-trustee of an SNT established under 42 U.S.C. § 1396p(d)(4)(A) obtained approval from the N.J. Superior Court Chancery Division, Probate Part, for the SNT to purchase a home for the benefit of the beneficiary and for a determination that certain expenditures benefiting other family members who cared for the trust beneficiary would not deprive the trust beneficiary of Medicaid benefits if such an application were made in the future. The Medicaid agency appealed the portion of the order regarding the effect of the expenditures on the trust beneficiary's future Medicaid eligibility on the grounds that the order went beyond the court's subject matter jurisdiction. The appellate court agreed with the Medicaid agency and held that only the Medicaid agency could determine the effect of the expenditures on the trust beneficiary's Medicaid eligibility. Finding that the lower court's determina-

32 *Id.* at 451–452.

33 35 A.D.3d 301, 827 N.Y.S.2d 50, 2006 N.Y. slip op. 10116 (N.Y. App. Div. 1st Dept. 2006).

34 35 A.D.3d at 301–302.

35 430 N.J. Super. 235, 63 A.3d 764 (N.J. Super. App. Div. 2013).

tion that the expenditures were for the sole benefit of the beneficiary was supported by the record, and that the court below could determine that the trust was not therefore violated, the appellate court nevertheless concluded that the lower court's determination could not bind the Medicaid agency's eligibility determination.[36]

Because the sole benefit rule generally does not apply to third-party trusts, other residents may be able to live in the home without paying a pro rata share unless the terms of the trust specify otherwise. The trustee of a third-party trust, however, still must consider whether there are sufficient assets and income in the trust given the costs of maintaining the home and the other goods and services that the beneficiary will need over his or her lifetime when the other residents cannot or will not contribute a pro rata share.

3. Knowledge of Public Benefit Rules

Another unique responsibility of the SNT trustee is the duty to administer the trust in a way that does not interfere with the trust beneficiary's eligibility for public benefits and to pursue available benefits for the trust beneficiary whenever available. This requires the trustee to have knowledge of available public and private benefit programs and their eligibility criteria so that the trust can be administered in a way that supplements but does not supplant those benefits. Courts are increasingly holding SNT trustees accountable for having this specialized knowledge. For example, in *Sargent v. Sargent*,[37] the trial court held that the trustee breached her duty to administer the trust by performing arbitrary acts and by failing to make distributions for the benefit of the trust beneficiary. The case involved a revocable trust that was to be divided upon the death of the settlor into four separate shares that would continue to be held in trust, with one of those shares being held in an SNT. The trustee refused to purchase a condominium for the benefit of the SNT beneficiary, citing concerns with public benefits eligibility despite being reassured by the beneficiary's attorney that purchasing the condominium would not interfere with the beneficiary's benefits. The court found that the trustee failed to properly separate the shares and breached her fiduciary duty by not administering the trust according to its terms and by failing to learn about the needs of the SNT beneficiary.[38]

4. Required Payback Provision for Self-Settled Trusts

After the death of the beneficiary, the trustee of a self-settled SNT created under 42 U.S.C. § 1396p(d)(4)(A) is required to reimburse the state Medicaid agency for benefits paid on behalf of the trust beneficiary. If the trust corpus is insufficient to cover the full reimbursement claim, state Medicaid agencies can be aggressive in reviewing the administration of the trust to determine whether distributions were proper under the terms of the trust and whether they were made for the sole benefit of the trust beneficiary.

For self-settled trusts, upon the death of the trust beneficiary, the home is subject to the trust's payback provision. Pursuant to U.S.C. § 1396p(d)(4)(A), an SNT funded with the assets of a beneficiary with disabilities must contain a

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36 430 N.J. Super. at 246, 63 A.3d at 771.

37 2009 R.I. Super., LEXIS 109, 2009 WL 3328560 (R.I. Super. Ct. July 31, 2009); *see also* clarifying order, *Sargent v. Sargent*, C.A. PC08-1429 (R.I. Super. Apr. 13, 2011).

38 *Id.*, R.I. Super. at *10.

provision that the state Medicaid agency be reimbursed dollar for dollar, upon the beneficiary's death or earlier if the trust is terminated, for all expenditures made on behalf of the beneficiary during his or her lifetime. Therefore, if the beneficiary dies, the trustee may have to sell the home in order to satisfy the payback provision, thereby displacing the other family members living in the home. If the other occupants refuse to move, the trustee may have to initiate eviction proceedings. Even if the other occupants are willing to move, they may be unable to afford a similar-sized home in the same or similar neighborhood. This can be extremely upsetting to school-age family members of the beneficiary and their parents.

5. Liability Concerns

Another significant concern is the trust's exposure to liability for expenses related to maintenance, upkeep, and repairs as well as for liability for third-party injuries incurred on the property. Family members or others residing in the home owned by the trust may not be interested in maintaining, or may be unable to maintain, the home. The trustee may not be aware that someone illegally rewired the home or that there are holes in the walls. The trustee, however, is responsible for maintaining the trust property.

If a trust owns real estate, adequate property and liability insurance is absolutely essential to protect both the beneficiary and the trustee from liability. For resident and nonresident real property, the trustee may want to consider hiring a professional property manager to oversee the property.

If the beneficiary has physical disabilities, the home may need to be renovated to accommodate those disabilities. For example, if the beneficiary is unable to walk, it may be necessary to add a bedroom and bathroom to the first floor and wheelchair ramps outside the home. The beneficiary may also require shower or other modifications as he or she grows or ages. Although the addition of a new bedroom or bathroom may add value to the property, other modifications may reduce the value of the property. Trustees in most states are governed by prudent investor laws.[39] The trustee must determine whether it is economically feasible to purchase and modify a home.

Because the purchase price of a home may not leave enough assets to maintain and/or improve the property or pay for the trust beneficiary's other needs, the trustee may seek to borrow money to pay for the home. As discussed in Section IV, if a trust purchases a home with a mortgage and the beneficiary lives in the home during the month of purchase, the home is considered ISM during that month.[40] The monthly mortgage payment is also considered ISM, causing an SSI benefits reduction of no more than the PMV.[41] In addition, the trustee may find that the trust income and/or assets are insufficient to make the mortgage payments, and the beneficiary's income may be insufficient too.

The cost of home ownership can deplete the trust assets over the years, and many trustees find that they are unable to maintain the home. Consider the following example. An SNT is funded with $1 million when the trust beneficiary, who is quadriplegic, is 6 years old. A house is purchased for $350,000 with the trust assets. Modifications are made to the prop-

39 *See* Unif. Prudent Investor Act (Ref. & Annos) (1994). http://www.uniformlaws.org/Act.aspx?title=Prudent%20Investor%20Act.

40 POMS SI 01120.200(F)(3)(b) (Dec. 11, 2013).

41 *Id.*

erty to accommodate the beneficiary's wheelchair. Real property taxes exceed $8,000 per year. Five years later, the furnace needs to be replaced. Ten years later, the air conditioning unit needs to be replaced and the roof needs repairs. The trust pays $1,500 per year for homeowners' insurance. The trust also pays for lawn maintenance, snow removal, heating fuel, electricity, water, sewer service, and trash collection. About 12 years later, modifications need to be made to the shower because the beneficiary has grown. The trustee receives statutory commissions, and the stock market has suffered a downturn. The trust simply cannot afford to continue to maintain the home.

Family members often advocate for a home with a pool. In some instances, a pool may be therapeutic for the disabled beneficiary; however, in many cases, the family members just want to enjoy a pool. Similarly, family members may want an upgraded kitchen or bathroom as long as the kitchen or bathroom is being modified anyway for use by a trust beneficiary who uses a wheelchair, or they may request a Jacuzzi bathtub. The SSA or state Medicaid agency may question these expenditures and conclude that they are luxuries that do not benefit the trust beneficiary. The trustee may be held liable for expenditures that are not for the sole benefit of the disabled beneficiary, and the beneficiary may be disqualified from means-tested benefits.

Because the sole benefit rule does not apply to third-party trusts, the trustee of such a trust may have more flexibility in such purchases. Nevertheless, the trustee may still be governed by the state's prudent investor rules and must consider whether such purchases are prudent in light of the disabled beneficiary's lifetime needs.

6. Income Tax Considerations

For third-party SNTs, upon the sale of the property, there is no exemption from capital gains tax if the property has appreciated in value.[42] A homeowner who lived in his or her primary residence for at least 2 of the past 5 years may be entitled a principal residence exclusion pursuant to section 121 of the Internal Revenue Code.[43] A single homeowner is eligible for a $250,000 exclusion, and married homeowners filing jointly are eligible for a $500,000 exclusion.[44] As a result of these exclusions, a capital gains tax does not need to be paid upon the sale of a primary residence if the profit is less than the applicable exclusion amounts.

Under § 121, the homeowner is permitted to aggregate the amount of time he or she resides in the home to meet the 2-year residency prerequisite. The homeowner may take advantage of the principal residence exclusion once every 2 years, and the amount of times that the exclusion is available is unlimited as long as the taxpayer meets the requirements.[45] Both spouses must meet the requirements to qualify for the $500,000 exclusion.

If a homeowner who becomes physically or mentally incapable of caring for himself or herself resides in the home for periods aggregating at least 1 year, there is an entitlement to the principal residence exclusion. This is true even if the homeowner resides in a facility during the 5-year period, such as in a nursing home licensed by a state or political subdivision to take care of the homeowner in his or her condition.[46]

An SNT established under 42 U.S.C. §

42 Rev. Rul. 85-45, 1985-1 C.B. 183.

43 26 U.S.C. § 121(a).

44 26 U.S.C. § 121(b)(1), (2).

45 26 U.S.C. § 121(b)(3).

46 26 U.S.C. § 121(d)(7).

1396p(d)(4)(A) generally is classified as a grantor trust for income tax purposes because the trust is funded with the assets of the disabled beneficiary who enjoys a beneficial interest in the trust property even though that interest may be restricted. Accordingly, the trust income is taxed to the beneficiary with disabilities[47] and the principal residence exclusion is available to the trust beneficiary when the trustee sells the home. When a trustee of a third-party trust sells a home; however, because third-party trusts are nongrantor trusts, the principal residence exclusion is not available and income on any amount of capital gains is subject to taxation.[48]

V. Conclusion

Because of all the potential pitfalls of holding real property in an SNT, some trustees refuse to do so in all cases. Others evaluate the situation on a case-by-case basis. This evaluation must include all of the issues outlined in this article, including the financial feasibility of maintaining the property, sole benefit considerations, and the impact on means-tested benefits for the trust beneficiary. To protect against a breach of fiduciary responsibility, an SNT trustee must be very aware of his or her powers, duties, and responsibilities in administering trust property to protect the interests of the trust beneficiary and administer the trust in a way that maximizes benefits to the trust beneficiary without interfering with his or her eligibility for public benefits.

47 26 U.S.C. § 671.

48 Rev. Rul. 85-45, 1985-1 C.B. 183.