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Report From Counsel

Insights and Developments in the Law **Summer 2006**

Special Needs Trust Planning for Disabled Children

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What Is a Special Needs or Supplemental Needs Trust?

A special needs trust is sometimes referred to as a "supplemental needs trust". Typically, this kind of trust is an irrevocable trust created during the grantor's life that is designed to supplement a handicapped or disabled individual's support needs without jeopardizing or reducing that person's eligibility for private, federal or state support and by also protecting the trust assets from that person's creditors.

A special needs trust may also be created by Will or in a revocable inter vivos trust upon the death of the grantor.

In any event, a special needs trust is structured as a "discretionary" trust that gives the trustee of such a trust the complete discretion to make distributions of income and/or principal to or for the benefit of the trust's beneficiary. In such a trust, the trust assets can only be used for the "supplemental needs" of the beneficiary which avoids the disqualification of the beneficiary from receiving governmental assistance and further prevents the beneficiary's creditors from attacking trust assets. As a result, the selection of an appropriate trustee becomes critical since that trustee will be using his or her judgment in dispensing trust income or principal only for the supplemental needs of the beneficiary.

A discretionary special needs trust can be an effective and flexible vehicle to manage assets for the benefit of a disabled beneficiary without losing governmental assistance. However, a special needs trust must not be "self-settled", i.e., the trust should not be established with the assets of the disabled person, unless the trust reimburses the government at death for services furnished to the beneficiary during his or her life. A discretionary special needs trust funded with the beneficiary's assets, regardless of whether it is created by the beneficiary, the beneficiary's parent, spouse or guardian, is classified as a "Medicaid Qualifying Trust" and will protect the beneficiary only to the extent permitted under Medicaid rules.

Special needs trusts are used to create a fund to assist in the support of a disabled child or relative and to support the elderly.

Medicaid rules are extremely complex and are designed to limit the amount of assets that a recipient of benefits can own or earn each year benefits are paid. Current law denies Medicaid eligibility if assets were transferred less than 36 months before application is made for benefits. A 60 month "look back period" applies to payments from certain trusts as well. This area of law varies from state to state, thereby requiring the need for competent advice.

When Should a Special Needs Trust Be Used?

Special needs trusts are used to create a fund to assist in the support of a disabled child or relative and to support the elderly. Special needs trusts are also used to provide support to a spendthrift beneficiary who is not capable of managing his or her assets.

In the case of a disabled child, a problem arises when the parents are considering estate planning issues and a child is receiving or will be receiving governmental benefits. The problem to be confronted involves the threat of loss of public benefits if a disabled child inherits assets from a parent. This threat to the child's future governmental assistance will arise if the parents do not properly plan their estate. It is not necessary to disinherit the disabled child. Through the proper use of a special needs trust, the disabled child's benefits can be saved while still setting aside assets for that child's supplemental needs. To be effective, a special needs trust will preclude the disabled child beneficiary from having any power to assign, encumber, manage,

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Valuation Discounts for Estate and Gift Taxes

Upon the death of the owner of stock in a closely held corporation, the fair market value ("FMV") of the stock must be determined before an estate tax return can be filed. For gifts of such stock, it is also necessary to ascertain the value of the stock for gift tax purposes. Unlike publicly traded stock, the value of which can be determined easily on the Internet or in a newspaper, stock in a closely held business has a value that is more difficult to nail down. By definition, the shares are held by a much smaller number of people and are not widely traded.

The Internal Revenue Service likes to keep an eye on valuation discounts.

Fair market value means the price at which property would change hands between a willing buyer and a willing seller when neither party is under any compulsion to buy or sell and both parties have a reasonable knowledge of relevant facts. Calculating the FMV of closely held stock generally starts with an estimate of the total value of the closely held company itself. Application of discounts (or premiums) to account for the specific circumstances of the company then reduces (or increases) the FMV of the stock.

The process is highly focused on the particulars of each business. For example, in a recent decision by the United States Tax Court, the starting point in valuation of a decedent's minority interest in a closely held family corporation was easier to figure, because the corporation was a holding company with a portfolio of widely traded securities that had readily ascertainable values. But that market value was discounted by 10% to take into account a buyer's lack of control over the company and by another 15% for lack of marketability of the shares.

The Internal Revenue Service likes to keep an eye on valuation discounts, since they lead directly to a reduction in estate tax liability. Federal statutes, regulations, and Revenue Rulings have shed light on the use of valuation discounts. IRS Revenue Rulings have identified the following list of some primary criteria for determining the valuation discounts for closely held stock:

- nature and history of the business;
- outlook for the economy and the specific industry;
- book value of the stock and financial condition of the business;
- earning and dividend-paying capacities of the company;
- goodwill or other intangible value of the enterprise;
- sales of the stock and size of the block of stock to be valued; and
- market price of publicly traded stocks of corporations in the same or similar line of business.

The Hazards of Résumé Screening

It is popular now for employers to use screening tests, often administered on the Internet, to weed out a large portion of applicants for job openings before making the more difficult selections from among those who survive that first cut. Such tests are supposed to measure cognitive ability, personality characteristics, or, in fewer instances, the ability to perform in a simulation of the duties that the job requires. The easily administered and scored screening tests have their appeal, especially if you are charged with filling, say, 10 positions from 100 people who have submitted résumés.

A downside to screening tests is the risk that rejected applicants may persuade a court that the tests essentially were a tool to accomplish prohibited discrimination, even though that may not have been the employer's intent. For example, an employment test that impacts racial minorities or women disproportionately could lead to liability unless the employer can show that the test is sufficiently related to the job and is necessary to the employer's business.

Another potential pitfall stems from the prohibition in the Americans with Disabilities Act (ADA) against medical testing of job applicants. There sometimes is a fine distinction between acceptable personality or psychological tests and prohibited medical tests. The screening of applicants also could run afoul of some state statutes that protect against invasions of privacy.

When individuals adversely affected by a personality test challenged the test in federal litigation under the ADA, an appellate court struck down the test. The test, at least in some of its 502 questions, was a prohibited examination of the applicants' mental health. Its true or false questions went much farther than the acceptable lines of inquiry about matters such as working well in groups or in a fast-paced office. Instead, they ventured into the realm of psychiatric disorders. In this case, a prospective manager of a rent-to-own store could not be required to give true or false answers to statements such as: "I see things or animals or people around me that others do not see"; "At times I have fits of laughing and crying that I cannot control"; or "My soul sometimes leaves my body."

Eminent Domain Update

Landowner Loses the Battle but Wins the War

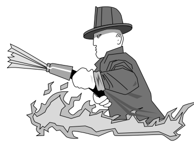
In one of the most controversial eminent domain decisions ever, the United States Supreme Court ruled in 2005 that a city's exercise of its eminent domain powers to take private property in furtherance of an economic development plan satisfied the constitutional requirement that such power be used only for a "public use," even though private developers stood to profit handsomely from the city's actions. In reaction to that ruling, some state legislatures have been busy crafting legislation to limit the use of condemnation powers in such circumstances. For their part, the owners of property targeted for condemnation have considered how they still might fend off the taking, or, failing that, how to maximize the compensation that the government must pay.

In a recent case, a landowner was not able to defeat a condemnation initiated by a city so that a new hotel could be built on the property, but he did receive maximum compensation from an obviously sympathetic jury. The landowner was an immigrant who had spent two years and a lot of money renovating a warehouse and building a mail-order cigar business. When two private developers were unsuccessful in negotiations to buy the property as a site for a hotel, they instead reached an agreement with the city whereby the city would condemn the property for their desired use and the developers would pay the costs and fees associated with the condemnation.

When the city was first attempting to buy the property, it sent the landowner a toxic waste notice requiring him to investigate whether any toxins existed in the ground. The landowner tried to comply, but after spending many thousands of dollars he found no toxins. The city would later admit in the litigation that such an investigation was not really feasible so long as a building remained on the property. The toxic waste notice, and especially its suspicious timing, came to be seen as a tactic to put pressure on the landowner during the negotiations leading up to the condemnation.

Although the trial court ruled that the city could condemn the land for the hotel, in the subsequent trial before a jury for damages, the landowner fared much better. The jury awarded him the entire amount he had sought. The award included several million dollars each for the value of the property itself and for the loss of the goodwill associated with the cigar business. Damages for loss of a business are not typical in condemnation cases, but the landowner was able to show that there was no suitable alternative location for the business, so that he would have to start over from scratch. For good measure, the jury also awarded damages equal to the cost of the dubious toxicity study that the landowner had been forced to undertake.

Smoke Alarms: Inexpensive Guardian Angels



If you could pay $10 and, in return, get a guard who would warn your family if your house caught fire, would you? Of course you would. Despite this, most people do not have enough smoke detectors in their homes—detectors that will stand guard over your family's lives 24 hours a day. The evidence shows that using even an inexpensive smoke detector increases your family's chance of surviving a house fire by 50%, making it one of the best investments you can make for your family's safety.

Experts recommend installing smoke detectors, the cheapest of which start at about $10, throughout your house. At a minimum, install one detector for every floor and one outside of each bedroom. Test your smoke alarms once a month, and replace the batteries once a year. Make sure that every member of your family knows (1) what to do when the smoke alarm sounds, and (2) the fire escape route from each room. A little advance planning can help make sure that you and your family have a better chance if a fire should start in the night.

Actual resolution of legal issues depends upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects, but rather to provide insight into legal developments and issues. The reader should always consult with legal counsel before taking action on matters covered by this newsletter.

Special Needs Trust

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direct, distribute or in any way require the trustee to make distributions from the trust. The trustee shall, in his or her absolute discretion, use trust assets for the needs of the beneficiary that are not satisfied through governmental assistance. In that way, the child's eligibility for governmental assistance is not impaired.

How Should a Special Needs Trust Be Structured?

The optimum structure for a special needs trust involves the following elements:

1. The trust is irrevocable and is created during grantor's life.
2. The grantor of the trust should not be the beneficiary or remainderman.
3. The trust should not be funded with the beneficiary's assets. If it is, then the remainderman must be a qualified government entity.
4. The grantor should not retain any control over the trust assets.
5. The trust should not discharge grantor's obligation to support the beneficiary.
6. The trustee should not be the grantor, grantor's spouse, the beneficiary or any other party who would jeopardize the intent or function of the trust.
7. The trust should terminate upon the beneficiary's death.
8. The trustee should have absolute and sole discretion to distribute trust assets for the supplemental needs of the beneficiary.
9. The trust should contain a spendthrift provision.
10. A statement of the grantor's intent for the trust.
11. A direction that the trustee consider other resources of the beneficiary before making distributions.
12. A direction to the trustee that his or her discretion to distribute should only be exercised if the beneficiary's eligibility for government benefits will not be jeopardized.
13. A direction to the trustee to maximize use of government programs to pay for cost of beneficiary's care.
14. A provision allowing the trustee to accumulate income.
15. A provision that devises trust assets to remainderman upon death of the beneficiary or in the event of trust disqualification.

What Are the Income Tax Implications of a Special Needs Trust?

Assuming the trust is irrevocable, the trust shall pay tax on income retained and the beneficiary shall pay income tax on taxable income distributed to him or her.

Any donor who makes a gift to fund the trust makes a taxable gift subject to the donor's annual exclusion and unified credit available.

Unless there is a transfer that is subject to the three year recapture rule for gifts made in contemplation of death, the trust assets are not includable in the donor's gross estate for federal estate tax purposes.

Sports Injuries

Fan Hit by Foul Ball

Practically since our national pastime was in its infancy, operators of baseball stadiums have benefited from a more limited duty to spectators than that which generally applies to businesses that invite the public to come onto their property. Alone among spectator sports, baseball has fans who actively try to catch errant balls, sometimes even risking life and limb to get one. Even if fans would just as soon avoid the batted or thrown balls, the law has assumed that they are aware of the risks from these balls when they take their seats in the stands. The limited duty favoring fans generally is met if seats with protective screening are provided for as many people as normally would want them.

But what of the unsuspecting fan who is clobbered by a foul ball when he has left the sanctuary of his screen-protected seat to get a beer from a vendor? That was the misfortune of a fan who overcame the limited-duty rule when he sued a minor league baseball team for his injuries. A state supreme court ruled that his lawsuit could proceed under ordinary negligence principles.

The limited-duty rule for baseball fans loses its rationale when an injury from a flying ball occurs somewhere other than in the stands. In other areas of a stadium, it is foreseeable and predictable that fans will let down their guard. They may not even be paying attention to the game at such times and places, nor should they have to for their own safety. In the case at hand, when he was struck by the ball, the fan was chatting with other people in the line for concessions, and he could not have seen the batter hit the ball even if he had tried.

The court's concern for fans was heightened by some changes in baseball as a spectator sport. Children and seniors frequently attend professional baseball games. Today's players hit baseballs harder and farther. In keeping with the notion of the sport as multifaceted entertainment, ballparks today present what one observer has called "a sensory overload of distractions." As the court observed, "the beauty of common law is the ability to adapt to the times."