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The Advanced Consulting Group | Special-needs trust planning

Help relieve caregiver worries with a plan

Special-needs trust planning with life insurance and annuities

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Caregivers for individuals with special needs rise up and overcome unique concerns every day. However, in the back of their minds, they may worry most about how their loved one with special needs will be cared for should something happen to them.

This booklet offers a discussion and common examples about how financial professionals can design solutions to ensure that the individual with special needs is well cared for should something happen to their caregiver.

Trusts are the cornerstone of special-needs planning

The first step in special-needs planning is identifying who has the ability and willingness to care for the person with special needs after the caregiver passes away. Giving another trusted, competent adult or professional the authority to manage funds on behalf of the individual with special needs — and the fiduciary duty to expend those funds in that individual's best interest — can be accomplished by establishing a trust.

In general, there are two forms of special-needs trusts:

- **Supplemental special-needs trusts** preserve access to government benefits while providing resources for medical equipment and supplies, travel, personal care services and many other things that are not necessities or provided for by government programs
- **Support special-needs trusts** are designed for clients who may prefer to provide for the primary support of the individual, outside of the purview and limitations of government benefits

Preparing a trust document requires the services of legal counsel.

A trust is a three-party fiduciary relationship in which the caregiver (the grantor) transfers property to a second party (the trustee) for the benefit of the individual with special needs (the beneficiary).

Insurance products can provide certainty when there’s uncertainty

To be effective, the trust must be funded.

Life insurance may be particularly suitable to meet this need, as it can create a large fund for a relatively small periodic premium. Annuities can also be an effective product to use to protect the IRA assets of the parent that will be left to the trust or used as an investment in the trust for tax deferral and protection. When used in conjunction with a trust, life insurance and annuities can provide financial certainty for the care of a person with special needs.

Over the next few pages, we will present three case studies in which a life insurance policy or annuity is used to fund a trust that will provide financial support for a person with special needs.

A fourth case study explains how a trustee can use an annuity to grow tax-deferred assets that may serve as a secondary source of funds to support a person with special needs and then, after the individual passes, continue to support the trust’s objectives.

Case study 1

Survivorship life insurance payable to a testamentary special-needs trust
The basics

Who may be interested

Caregivers of individuals with special needs, including parents, the individual's parent and sibling, or the individual's siblings

Scenario

Mike and Carol (40), parents of Cindy (8), a child with special needs, want to provide extra financial resources for Cindy after their passing, while not jeopardizing her eligibility for government benefits (e.g., Medicaid).

Steps

1. A. Purchase a survivorship life insurance policy insuring Mike and Carol.

   B. Create a will for each parent with supplemental special-needs trust language.

   C. Designate the trust as the life insurance beneficiary.
2. When the surviving spouse passes, the special-needs trust is established according to specifications in the will, and the life policy's death benefit is paid to it.
3. The trustee will use the life policy's death benefit to pay for a variety of goods and services that maintain or enhance Cindy's quality of life.

Life insurance structure

- **Joint owners —** Parents
- **Insureds —** Parents
- **Beneficiary —** Trust under the surviving insured's last will and testament
- **Contingent beneficiary —** Children or another appropriate beneficiary
- **Premiums paid —** From either parent's bank account or a joint account

Benefits

Leverage of caregiver resources — For a relatively small periodic premium payment, parents can create a large trust fund to benefit their child.

Tax-advantaged cash value growth — While the parents own the life insurance policy, they are not subject to income tax on the annual growth in the cash value.

Tax-free death benefit — The trustee will receive the death benefit income tax free, further enhancing the benefits that can be paid on behalf of the beneficiary.

Product considerations

- Single life or survivorship products may be used
- Cash value accumulation can allow caregivers to access cash in an emergency
- Riders, such as those for long-term care, may be available for the insureds
- Limited-pay or full-pay designs are possible

Case study 1

Survivorship life insurance payable to a testamentary special-needs trust

How it works

1

A. Purchase a survivorship life insurance plicy insuring Mike and Carol.

Life policy

B. Create a will for each parent with supplimental special-needs trust language.

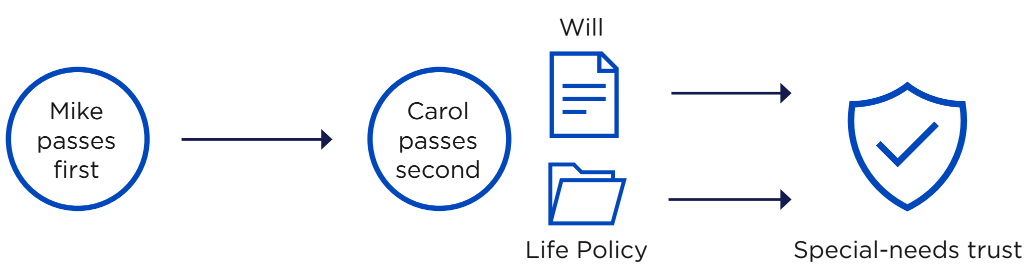
Mike

Carol

C. Designate the trust as the life insurance beneficiary.

Special-needs trust

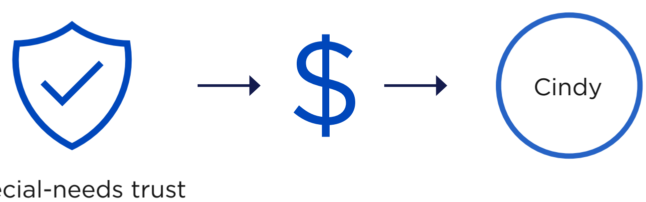
2



When the surviving spouse passes, the special-needs trust is established and the life policy's death benefit is paid to it.

3

The Trustee Will use the Life policy's death benefit to pay for a varietyof goods and services that will maintain or enhance Cindy's quality of life.



Case study 2

Individual life insurance policy payable to a pooled special-needs trust
The basics

Who may be interested: Caregivers of individuals with special needs who do not have the resources to create a trust or a trusted individual to name as trustee

Scenario: Jane (65) is a single mom and the parent of an only child, David (40), with special needs. Jane doesn't have any close friends or family members who could care for David after she passes away, so she has established an account for David at a local nonprofit that runs a pooled (community) special-needs trust.

Steps

1. A. Purchase a life insurance policy insuring Jane. B. Name David's account in the pooled trust as beneficiary of the life insurance policy.
2. A. At Jane's passing, the death benefit will be paid to the pooled special-needs trust. B. The trustee can use the money to pay for a variety of goods and services that maintain or enhance David's quality of life.
3. At David's passing, any funds remaining in his account will be retained by the nonprofit and may be used for the benefit of other individuals with special needs.

Life insurance structure

- **Owner —** Caregiver
- **Insured —** Caregiver
- **Beneficiary —** Pooled special-needs trust
- **Premiums paid —** From the caregiver's bank account

Benefits

Leverage of caregiver resources — For a relatively small periodic premium payment, parents can create a large trust fund to benefit their child.

Leverage resources of pooled special-needs trust — This includes expert trust administration; there's no need to create an individual trust and appoint an individual trustee.

Tax-deferred cash value growth — While the caregiver owns the life insurance policy, he/she is not subject to income tax on the annual growth of cash value.

Tax-free death benefit — The trustee of the pooled special-needs trust will receive the death benefit income tax free, further enhancing the benefits that can be paid on behalf of an individual with special needs.

Product considerations

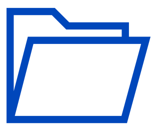
- Single life or survivorship products may be used
- Cash value accumulation can allow caregivers to access cash in an emergency
- Riders, such as those for long-term care, may be available for the insureds
- Limited-pay or full-pay designs are possible

Case study 2

Individual life insurance policy payable to a pooled special-needs trust
How it works

1

A. Purchase a life insurance policy on Jane, the mother



Life Policy

B. Name the pooled trust as beneficiary of the life insurance policy

Pooled Special-needs trust

2

A. At Jane's passing, the death benefit will be paid to the pooled special-needs trust.

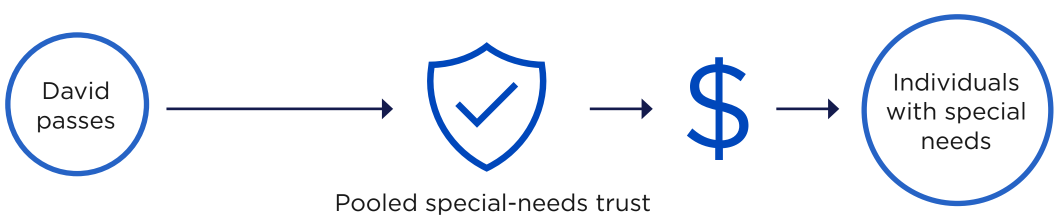
B. The trustee can use the money to pay for a variety of goods and services that maintain or enhance David's quality of life.

Life policy

Pooled special-needs trust

3

At David's passing,, any funds remaining in his account will be retained by the nonprofit and may be used for the benefit of other individuals with special needs.



Pooled special-needs trust

Case study 3

IRA deferred annuity to fund a special-needs trust
The basics

Who may be interested: Caregivers who have significant value in a qualified plan or IRA and want the potential upside on their investments but also the certainty of death benefit protection.

Scenario: Naoko, an IRA owner who cares for Miceal, an individual with special needs, establishes a special-needs trust and names the trust as beneficiary of their IRA. The IRA owner then purchases a deferred annuity with death benefit protection.

Steps

1. A. Naoko, the IRA owner, establishes a special-needs trust. B. Naoko purchases a deferred annuity product with death benefit protection. C. Naoko names the special-needs trust as beneficiary of the IRA.
2. At Naoko's passing, the trustee will select the appropriate payout option for the IRA depending on the provisions of the trust (i.e., designated beneficiary, eligible designated beneficiary or nondesignated beneficiary).
3. The trust will receive distributions and accumulate or distribute them for the benefit of the person with special needs, based on the terms of the trust.

IRA structure

- **Owner —** Caregiver
- **Annuitant —** Caregiver
- **Primary beneficiary —** Special-needs trust
- **Contingent beneficiary —** Children or another appropriate beneficiary

Benefits

Death benefit protection — If the IRA owner passes while the annuity's contract value is less than the guaranteed death benefit amount, the trust, as beneficiary, will receive the guaranteed death benefit amount.

Growth potential — Death benefit protection gives the IRA owner the chance to grow the annuity's contract value through a more aggressive investing strategy inside the annuity than they might otherwise have done.

Product considerations

- Use a deferred annuity that has death benefit protection
- Any withdrawals will reduce the guaranteed death benefits under the contract
- Withdrawals may be subject to surrender charges

Tax considerations

While the IRA owner is alive, all pretax amounts withdrawn from the IRA will be taxable to the IRA owner and, unless an exception applies, may be subject to a 10% tax on pre-age 59½ distributions.

At the passing of the owner, the trust will become owner of the now-inherited IRA. The trust will be the taxpayer on the taxable portion of any distributions, unless those distributions are passed through to trust beneficiaries. No distributions will be subject to the 10% additional tax on premature distributions because the owner has passed away.

If a trust qualifies as a designated beneficiary of an IRA it inherits, it has until the end of the 10th year after the owner's passing to liquidate the entire IRA — unless it meets some limited exceptions allowing it to be treated as an eligible designated beneficiary. If it qualifies to be treated as an eligible designated beneficiary, then the trust can use the life expectancy of the special-needs individual to stretch out the required distribution.

The IRA owner should seek the guidance of a qualified attorney to determine whether the trust can be considered a designated beneficiary or an eligible designated beneficiary.

Case study 3

IRA deferred annuity to fund a special-needs trust
How it works

1

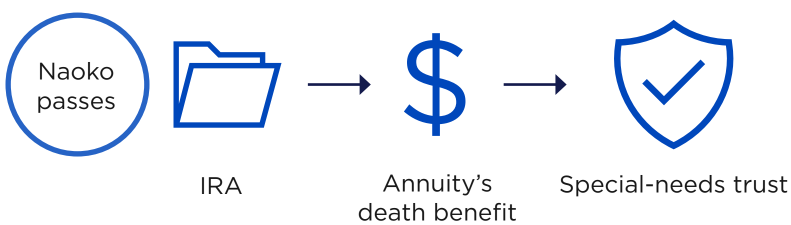
A. Naoko, the IRA owner, establishes a special-needs trust.

B. She then purchases a deferred annutiy inside her IRA

C. She then designates the special-needs trust as the beneficiary of the IRA.

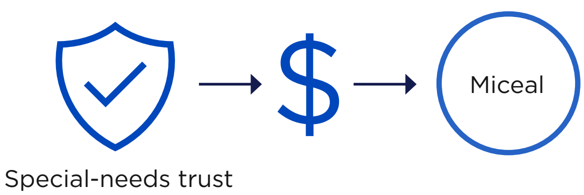
2

At Naoko's death, the special-needs trust inherits the IRA at the potentially stepped-up death benefit amount.

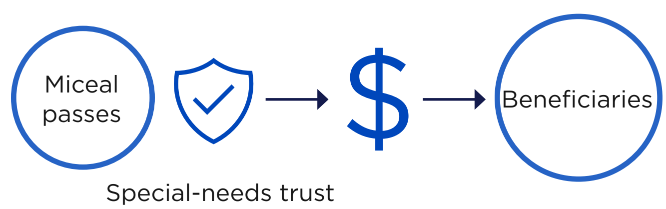


3

The special-needs trust distrubutes money as needed to support care for and enhance the quality of life of Miceal, the primary beneficiary.



At Miceal's passing, the special-needs trust distrubutes money to remainder beneficiaries per the terms of the trust.



Case study 4

Special-needs trust owns a nonqualified deferred annuity
The basics

Who may be interested: Trustees who want to provide for an individual with special needs and are looking for tax-deferred accumulation with death benefit protection.

Scenario: An irrevocable nongrantor supplemental special-needs trust that was created by the parents of a person with special needs has been fully funded at the passing of the second parent. Now, the trustee wants an appropriate way to invest these funds going forward, with goals of growing the assets in a protected manner, limiting taxation and retaining enough liquidity to make distributions as needed.

Steps

1. Grantor fully funds the trust while alive or at time of passing.
2. The trustee purchases a nonqualified deferred annuity with some of the trust's proceeds.
3. The trustee can distribute income for the benefit of the individual with special needs first from the trust's (nonannuity) assets, then from the annuity if necessary.
4. At the passing of the individual with special needs (the annuitant), the annuity's death benefit is paid to the trust. The trust either retains the funds and reinvests them or distributes the proceeds to the trust's remainder beneficiaries.

Deferred annuity structure:

- **Owner —** Supplemental special-needs trust
- **Annuitant —** Individual with special needs
- **Primary beneficiary —** Supplemental special-needs trust
- **Contingent beneficiary —** Other children or another appropriate beneficiary

Benefits

Tax deferral — When a trust is the taxpayer (as it is with an irrevocable nongrantor trust), its tax brackets have lower income thresholds than for individuals, causing trust income to reach higher ordinary income tax rates more quickly than it would for individuals. Many types of investments can create ongoing taxable income.

On the other hand, the growth of a deferred annuity avoids taxation until an actual distribution is taken. This tax deferral of an annuity's growth can be of value to a trust that is designed to limit distributions and accumulate assets by giving the trustee the power to determine when any taxable distributions are taken.

Protect remainder beneficiaries' interests — Annuity death benefit protections allow the trust to insulate its remainder beneficiaries from loss if the annuitant (typically the person with special needs) passes in a situation such that the annuity's contract value is less than the annuity's guaranteed death benefit amount at the time of the annuitant's passing.

Product considerations

- Use a deferred annuity that has death benefit protection
- Any withdrawals will reduce the guaranteed death benefit under the contract
- Withdrawals may be subject to surrender charges

Tax considerations

For a trust to receive tax deferral on annuities owned by the trust, it must be considered as acting as an agent for a natural person; if all the trust beneficiaries are natural people, a trust generally receives tax deferral.

Unrealized gains from a trust-owned annuity is not currently taxed; however, if distributions are taken from the annuity, they will come from gains first, and either the trust or trust beneficiaries (if the distributions are passed through to them) will include the annuity distributions as taxable income.

If trust assets are sold to purchase an annuity, the gain on the sale of those assets may be taxable income to the trust.

If distributions are taken from the annuity when the trust is the owner and prior to the passing of the annuitant, there may be a 10% premature distribution tax penalty on the taxable portion.

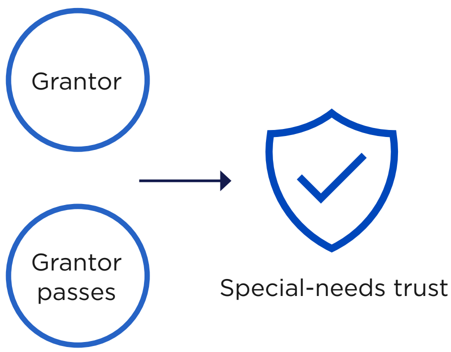
When the annuitant on a trust-owned annuity passes, a distribution must occur, and the gain in the policy will be taxable when withdrawn.

A change of annuitant on a trust-owned annuity policy creates a taxable event on the gain in the annuity.

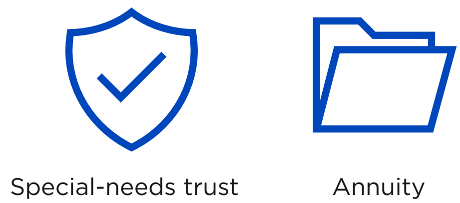
Case study 4

Special-needs trust owns a nonqualified deferred annuity
How it works

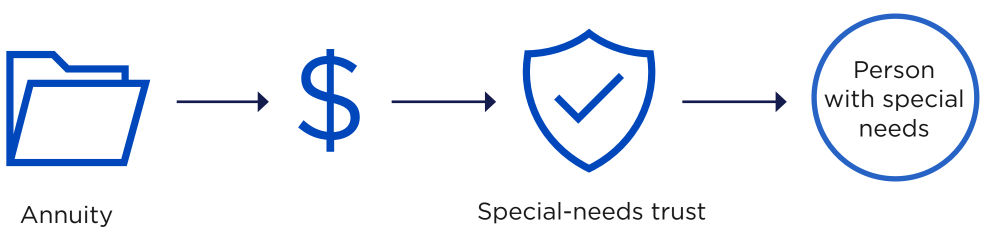
1 The grantor (typically parents) fully funds the trust while alive or at the time of passing



2 The trustee purchases a nonqualified deferred annuity with some of the trust's proceeds

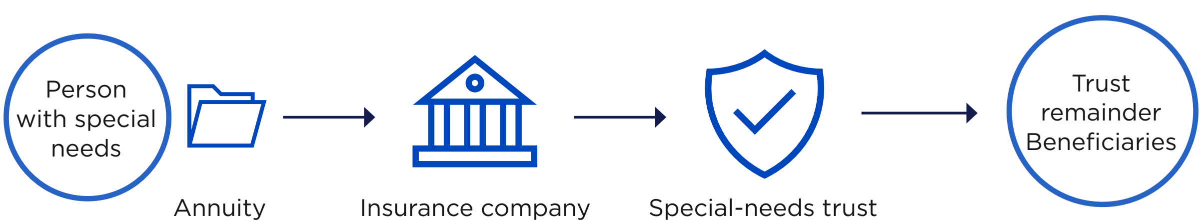


3 The trustee can distribute income for the benefit of the individual with special needs first from the trust (nonannuity) assets, then from the annuity if nessary.



4 At the passing of the individual with special needs (the annuitant), the annuity's death benefit is paid to the trust. The trust either retains the funds and reinvests them or distributes the proceeds to the trust's remainder beneficiaries.

The annuitant passes



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