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How Can You Support Families With Special Needs?

By Sophia Duffy, CPA, JD

Help your clients secure the future for their special needs children through tax and estate planning.

THE TERM “SPECIAL NEEDS” has expanded greatly over the past several years. Once used to describe only the physically or significantly mentally impaired, special needs now refers to a wide range of individuals with varying physical and mental capabilities. Per the 2010 Census, 18.7 percent of the general population (not in prison or hospitalized) has some form of disability. In addition, about 12.3 million people aged 6 years and older (4.4 percent) needed assistance with one or more activities of daily living. Recent studies claim that one out of every 88 children has some form of autism. Interestingly, autism diagnoses are more common in children from higher-income families. Disabilities can differ widely, and not all are immediately apparent, such as arthritis, developmental delays, seizure disorders, ADD/ADHD and mental illnesses.
For financial professionals, it is more and more common to come across clients who require planning specifically tailored to individuals with special needs.

The financial issues that families with special needs members face are unique. Less than one-half of disabled individuals aged 21 to 64 are employed. In comparison, the employment rate for people in this age group without disabilities is 79 percent. One significant issue is the caretaker burden placed on parents of special needs children. Eighty-six percent of disabled people live with their families for their entire lives. One parent is often forced to remain unemployed to care for the child, reducing income potential for the family. These parents frequently end up caring for the disabled child and their own elderly parents at the same time. As these special needs children grow into adulthood, they are less likely to be employed or become financially independent from their parents. The parents become elderly caretakers and the entire family must live off of the parents’ retirement income. Most disabled children outlive their parents, so the need for financial planning in advance is critical. In addition, the cost of medical care has skyrocketed in recent decades, and special needs care is no exception. Significant expenses for the special needs child commonly include modified vehicles and household equipment, home remodeling, and physical and cognitive therapy.

Clearly, there is a need for these families to work with financial advisors to ensure the family’s financial security in the short and long term. And tax-planning and estate-planning opportunities for families with special needs individuals can minimize tax liabilities and maximize financial security.

**AVAILABLE TAX DEDUCTIONS**

Parents with special needs children are often unaware of the various available tax benefits that apply to their families. Some common tax advantages are medical deductions (subject to the 10 percent adjusted gross income, or AGI, threshold), dependent deductions, work expenses related to impairment and the earned income tax credit.

Generally, costs for education are not deductible as medical expenses. However, the unreimbursed cost of attending an eligible institution for special needs may be deductible if incurred for a neurologically or physically handicapped individual. To be deductible, the principal reason for attendance must be to alleviate the handicap through the resources of the school or institution. In addition, costs for lodging, meals and transportation to and from the school are also deductible. The IRS has strict guidelines on what qualifies as an eligible institution.

Generally, capital expenditures are not permitted as a medical expense deduction, but a deduction is available when the capital expenditure is made to acquire an asset primarily for the medical care of the disabled individual. To be deductible, the expenditure must be necessary and reasonable. Common deductions include expenditures that improve or better the
taxpayer’s home, such as installing a swimming pool for arthritis or remodeling the home for wheelchair access. Some of these deductions are allowed only to the extent that the cost exceeds the increase in the property’s fair market value as a result of the capital expenditure. Costs to operate or maintain the capital expenditure are also deductible.

Registration fees and travel expenses are deductible for medical conferences and seminars in order to learn more about their child’s disability. To ensure their medical deduction, parents must attend the conference or seminar per the recommendation of the child’s doctor. Meals and/or lodging costs incurred while attending the conference are not deductible. The conference or seminar must deal specifically with the medical condition from which the child suffers, not just general health and well-being issues.

Deductions for dependents with special needs are more flexible than general dependent deduction rules. A disabled individual is eligible for a dependency deduction as a “qualifying child” if the person is totally and permanently disabled at any time during the year. This means that grandparents, uncles, aunts, brothers and sisters may qualify for the deduction. Note, however, that the other dependency requirements (for example, residency, support, citizenship) must also be satisfied. A disabled qualifying child is exempt from the requirement that he or she be younger than the individual claiming the dependency exemption.

Special needs individuals are entitled to claim itemized deductions for their unreimbursed impairment-related work expenses. The expenses must represent expenditures necessary to enable the individual to maintain employment. As a Schedule A unreimbursed business expense, this deduction is not subject to the AGI limitation on miscellaneous itemized deductions.

Generally, a family may qualify for the Earned Income Tax Credit (EITC) based on the presence of two “qualifying children” in the taxpayer’s home. The definition of “qualifying child” under the EITC is the same as for dependency, so a disabled individual qualifies regardless of age. However, the EITC is not subject to the other dependency requirements (such as support, gross income, joint return and citizenship).

SPECIAL NEEDS TRUSTS

In addition to tax planning, estate planning using special needs trusts can help secure a family’s finances to care for an individual with special needs. Special needs trusts (SNTs) provide financial protection to disabled individuals by allowing funds to be set aside for that individual’s care without disqualifying them from receiving public assistance. Generally, an SNT cannot provide for basic medical care that is covered by public assistance programs; trust funds can only be spent on benefits to improve the person’s quality of life. Permissible expenditures from a special needs trust include:

- Medical services and equipment not covered by public benefits
- Household costs other than food
- Mortgage or rent
- Real property taxes
- Utilities such as heating fuel, gas, electricity, water, sewer and garbage removal
- One vehicle used for transporting the beneficiary and related auto maintenance
- Laundry services and supplies
- Nonfood groceries
- Over-the-counter medications

Special needs trusts were designed to protect individuals who are too wealthy to qualify for needs-based welfare programs such as Medicaid and Supplemental Security Income (SSI). Under these programs, eligible individuals must have income and resources below certain levels to qualify for assistance. These resource thresholds vary by state. A “resource” is cash or other real or personal property that an individual owns and could use for his or her support and maintenance. In a legal sense, if the individual has the right, authority or power to liquidate the property, or his share of the property, it is consid-
erred a resource. Therefore, a common conflict arises for caregivers who want to provide a comfortable life for a disabled individual but remain under the resource thresholds so they will still be eligible to receive benefits under these programs. Even after initially qualifying for the programs, eligibility can be lost if assets are transferred to the disabled individual, and the child will only be able to re-qualify for benefits when the funds have been exhausted. So families will often try to understate their financial condition in order to qualify. The most common technique used to meet Medicaid eligibility is transferring assets out of the disabled individual’s name. Congress anticipated this action, however, and imposed a “look-back” period of 60 months for the transfer of assets after February 8, 2006. Assets transferred during the look-back period are treated as resources, regardless of the motive.

This conflict leaves families in a bad spot, and some have been forced to look at disinheriting the disabled dependent or transferring assets to other adult children or third parties to care for the disabled child. However, disinheriting is a difficult emotional prospect, and selecting a person to care for the disabled child is risky because there is no legal duty to act in accordance with the transferor’s instructions. The third party is free to dispose of the assets as he or she sees fit. Therefore, Congress carved out SNTs as a solution to this situation.

Special needs trusts generally fall into two categories: those funded with the assets of the disabled individual and those funded with assets of a third party. Trusts funded with the individuals’ assets are known as D4A “Payback” or D4C “Pooled” trusts. Trusts funded with a third party’s assets are simply known as “Third Party Special Needs Trusts.” These trusts accomplish the same purpose of preserving assets for the disabled child, but they have different requirements and are appropriate in different situations. If properly set up, these trusts will not be counted among the disabled individual’s resources.

A Payback Trust is a trust established for the sole benefit of an individual with a disability under the age of 65 by the individual’s parent, grandparent, legal guardian or court. The trust must contain a Medicaid payback provision, which requires that at the death of the beneficiary, the trust must reimburse Medicaid for benefits paid for during the life of the beneficiary. The trust is funded with the assets of the disabled person, typically inheritance or lawsuit proceeds. To avoid having the trust treated as a resource, the trust should not direct distributions to be made for the support, health or maintenance of the beneficiary. D4A Trusts are included in the estate of the grantor/beneficiary for estate-planning purposes.

If the individual is over 65, a D4C Pooled Trust is a way for disabled individuals to place their own assets into a trust without disqualifying themselves from receiving public benefits. To be excluded as a resource, a pooled trust must provide that the trust is established and managed by a nonprofit association. A separate account is maintained for each beneficiary of the trust, but all accounts are pooled for investment and management purposes. Accounts in the trust are established solely for the benefit of the disabled individuals. The trust must also include a Medicaid payback provision. At the disabled individual’s death, any amounts not retained by the nonprofit association must be paid back to the state. The disabled individual cannot bequeath assets remaining in the trust to anyone; they must remain in the pooled trust for the benefit of the other disabled individuals.

A pooled trust has several advantages over the payback trusts, such as lower administrative fees (due to combined management and the trustee being a nonprofit organization), broader investment options and ease of execution because the trust is already established. The best time to use a pooled trust is when there is a modest corpus involved; that way, substantial assets are not lost to the state when the individual dies.

Third-party SNTs are created and funded with the assets of a person other than the disabled beneficiary. These trusts are not counted as a resource if the beneficiary has no control over trust distributions and no ability to revoke the trust. The trusts can be revocable, irrevocable or a life insurance trust. The great advantage of a third-party trust over one funded with the disabled individuals’ assets is that there is no Medicaid payback requirement. The trust may be funded by assets during the grantor’s life or at grantor’s death, and can be funded with property, investments, retirement accounts or life insurance. The trust corpus remaining at the death of the disabled beneficiary passes to remaining beneficiaries selected by the donor or testator. The disabled beneficiary has only a lifetime interest.

Families with special needs individuals are in great need for competent and compassionate financial advisors to guide them through the complexities of providing financial security for their disabled family members. You can use tax-planning and estate-planning strategies to help them achieve their goals.