

[8] Modifying Third-Party Trusts into a SNT

[a] Introduction

As noted in § 1.05[1], most SNTs, especially first-party or self-settled SNTs are drafted as irrevocable trusts.¹ Presumably this is to satisfy 42 U.S.C. § 1396p(d)(4)(A) that requires such self-settled trusts to be “established for the benefit of such individual,” the argument being that if the trust were revocable, the grantor could revoke the trust or utilize its assets for the benefit of someone other than the beneficiary.

Unfortunately, an uncritical analysis of this strategy leads many drafters (and even more unfortunately, some interpreters), to the conclusion that because the trust is irrevocable it is un-modifiable and as a result the beneficiary and the trustee are locked into the trust’s (supposedly) immutable provisions, regardless of whether those provisions are appropriate to the present circumstances. However, in the case of an existing trust, whether a SNT or another irrevocable trust that ought to have been created as a SNT, this is not true. Proper drafting at the outset can obviate the draconian consequences of “irrevocability” equaling “unmodifiable” and, where necessary, current trust law in most jurisdictions establishes statutory bases upon which interested parties can obtain judicial relief.

[b] Definitions

- “Irrevocable” means: “unalterable; committed beyond recall.”²
- “Modification” means “A change to something; an alteration. A qualification or limitation of something.”³ and
- “Amendment” means “A formal revision or addition proposed or made to a statute, constitution, pleading, order, or other instrument; specif., a change made by addition, deletion, or correction; esp., an alteration in wording . . . ; The process of making such a revision.amendment as of course. An amend-

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¹ See generally Clifton B. Kruse, Jr. *Third-Party and Self-Created Trusts*, Third Ed. (ABA 2002).

² *Black’s Law Dictionary* (8th ed. 2004).

³ *Black’s Law Dictionary* (8th ed. 2004).

ment, usu. to pleadings, that a party has a statutory right to apply for without the court's permission.amendment on court's own motion. A change to a pleading or other document by the judge without a motion from a party"⁴

Thus, logically, there is nothing in the definition of "irrevocable" that prevents an "irrevocable" document from being "amended" or "modified" (and for the balance of this discussion, the terms "modification" and "amendment" will be used interchangeably). The analogy the authors use with clients in discussing the concept is that of a wine bottle: If the bottle is the trust, the contents of the bottle (or a portion thereof) can be poured out and new wine added without changing the nature of the bottle; it is still a bottle of wine, albeit with different contents.

[9] Modification

[a] Revocable Trust vs. Irrevocable Trust

A SNT established by a third party for the benefit of a beneficiary with a disability and funded with the grantor's assets (not the assets of the beneficiary who has a disability) could certainly be created as a garden variety, revocable inter vivos trust. Since the assets of the trust are not the beneficiary's, the trust is not subject to any of the rules covering self-settled SNTs, discussed below. If the trust is revocable it is, by definition, modifiable and terminable at the whim of the grantor.¹ Since modifying or terminating revocable trusts is inherent in their structure, they will not be discussed further here. However, it should be kept in mind that such trusts frequently become irrevocable upon the death of the grantor and, at that point, may become subject to the considerations discussed below.

[b] Irrevocable Trusts

SNTs are most commonly created as irrevocable trusts and therefore this discussion will focus on the reasons and methods for modifying irrevocable SNTs.

[c] When and Why

A properly drafted SNT will contain provisions permitting its modification at any time and for any reason that is appropriate under the circumstances. What those circumstances are will depend on the nature of the individual trust, the primary beneficiary's condition, the trust's assets and any other factors the drafter deems appropriate.

On the other hand, many older SNTs and those drafted by inexperienced draftspersons lack provisions permitting modification. Unfortunately, it is the trusts lacking modification provisions that most frequently are in need of modification in order to fix problems that have arisen because of unanticipated situations. Examples of these situations can involve the status of the trust's beneficiary, changes in the law, changes

⁴ *Black's Law Dictionary* (8th ed. 2004).

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¹ See *Restatement of Trusts 3d* § 63. See also, e.g., California Probate Code §§ 15400 et seq. and Fla. Stat. § 733.707(3).

in the situs of the trust, or changes in the trust's corpus. In all of these cases, fixing the problem will probably involve modifying or sometimes revoking the trust.

The Restatement of Trusts sets forth a number of bases upon which a trust can be modified or revoked:

The Settlor of an inter vivos trust has the power to revoke or modify the trust to the extent the terms of the trust so provide.²

If the Settlor fails to expressly make provision for revocation or amendment, the question is one of interpretation.³

The Restatement further provides that the trust itself may grant the trustee, beneficiaries or third parties powers over modification or revocation.⁴

Under the Restatement, irrevocable trusts can generally be modified or terminated by the consent of all the beneficiaries. The exception to the general rule occurs when such termination or modification would be inconsistent with a material purpose of the trust. When this occurs the consent of the grantor is required. If the grantor is deceased, a court must determine that the reason(s) for the modification or termination outweigh the material purpose.⁵

Finally, the Restatement provides that a court may modify administrative or distributive provisions of a trust if circumstances not anticipated by the grantor require such modification to further the purposes of the trust.⁶ In fact, the Restatement goes so far as to state that it is the *duty* of a trustee to seek such relief in circumstances where failure to do so could cause substantial harm to the trust or its beneficiaries.⁷

[d] By The Trustee

By far one of the most common provisions authorizing modification grants that power to the trustee. For example, a simple clause:

The Trustee may, in the Trustee's sole and absolute discretion, amend this Trust to conform with subsequent changes in federal or state law or regulations established thereunder in order to better effect the purposes of the Trust. The Trustee shall disclose any Trust amendment with the next annual accounting. Further, the Trustee may petition to a court with jurisdiction over the Trust, or to a court where the Beneficiary lives, or where the Trust has property, for authority to amend the trust to better effect the purposes of the Trust.⁸

A more comprehensive clause:

² *Restatement of Trusts 3d* § 63(1).

³ *Restatement of Trusts 3d* § 63(2).

⁴ *Restatement of Trusts 3d* § 64.

⁵ *Restatement of Trusts 3d* § 65.

⁶ *Restatement of Trusts 3d* § 66(1).

⁷ *Restatement of Trusts 3d* § 66(2).

⁸ Mary T. Schmitt Smith, *A Trust Dissected: Article By Article*, Stetson University College of Law, Special Needs Trusts, 1999.

This trust is irrevocable and unamendable; provided however, that in the event that any provision of this trust fails to meet the financial eligibility requirements of any program of means-tested public benefits for which the beneficiary is or may be eligible, the then-acting trustee or trustees may, in his, her or their discretion, amend the trust to ensure eligibility for such benefits. Any such amendment shall be in a writing dated and signed by the trustee or trustees and duly-acknowledged. In no event shall said trustee have any power or authority under this Article which shall constitute a general power of appointment under Internal Revenue Code section 2041 and applicable regulations. In addition, nothing herein shall be construed as depriving any person of the right to seek modification or reformation of this under California Probate Code sections 15400-15414, or other California Probate Code sections then in effect that govern such trusts. In no event shall the beneficiary have any right or power to alter, amend, revoke or terminate the Trust, or any of the terms of the Trust instrument, in whole or in part. Furthermore, the beneficiary shall have no right, power or legal authority to direct the use of the trust corpus for the beneficiary's own support and maintenance.⁹

There is nothing wrong with granting this power to the trustee so long as the grantor is confident in the identity and ability of the trustee or successor trustee to act in an appropriate manner. If the various named trustees are all either professionals or persons or entities independent from and neutral to the beneficiary, this is probably not a problem. On the other hand, if any trustee or successor trustee may potentially be adverse to the beneficiary problems can arise. For example, if the trustee (or a successor trustee) is a sibling of the beneficiary and therefore, presumably a remainder beneficiary, such a person could easily be put in an adversarial posture to the beneficiary. This problem would as easily occur in connection with discretionary distributions, and the appropriateness of appointing a potentially adverse party as trustee in these circumstances is discussed in § 3.03[2].

If the trustee has the authority to modify the trust when appropriate (or necessary), but chooses not to do so, has the trustee breached his or her fiduciary duty? If the decision is within the discretion of the trustee (and most carefully drafted SNTs will go overboard to make sure *everything* is within the discretion of the trustee), can the non-exercise of that discretion be questioned, and if so, by whom?

It is inherent in trust law that the trustee must act in a fiduciary capacity. The Restatement, in defining what a trust is, states:

A trust, as the term is used in this Restatement when not qualified by the word "resulting" or "constructive," is a *fiduciary relationship* with respect to property, arising from a manifestation of intention to create that relationship and *subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons*, at least one of whom is not the sole trustee.¹⁰ [emphasis added]

⁹ Sterling L. Ross, Jr., *Special Needs Trusts*, in *Drafting California Irrevocable Trusts*, 3d Ed., 619, 660 (John R. Cohan, editor, Continuing Education of the Bar—California 2004).

¹⁰ *Restatement 3d* § 2.

Comment “b” to Restatement § 2 goes on to state:

Despite the differences in the legal circumstances and responsibilities of various fiduciaries, one characteristic is common to all: a person in a fiduciary relationship to another is under a duty to act for the benefit of the other as to matters within the scope of the relationship.¹¹

Thus, whether or not the trust document specifically sets forth language regarding the trustee’s duty *vis a vis* the beneficiary, it can (and should) be argued that the trustee, simply by virtue of his or her office, has a duty to the beneficiary to act in an appropriate manner. However, in the context of this discussion, if the trustee is the holder of the authority to modify the trust and elects not to do so for personal gain, who will act to protect the beneficiary’s interest if the beneficiary is unable to do so?

[e] By Third Party

It is with that question in mind, i.e., “Who will protect the beneficiary if the trustee does not, or the trustee turns out to be adverse to the beneficiary?”, that some drafters utilize the office of a “trust protector” or “special trustee,” either individually or as a member of a committee. For a general discussion of Trust Protectors, Special Trustees and Trust Advisory Committees, see § 4.09.

In some circumstances (especially when there is only one trust protector rather than a committee), it may be appropriate to vest the modification power in the trust protector rather than the trustee. This is particularly appropriate where the trustee (or a successor trustee) may, in certain circumstances, have a potentially adverse relationship to the beneficiary. In such cases, the trust can provide that where such a conflict arises, any powers held by the trustee automatically default to the trust protector. Alternatively, to avoid any question as to when such powers are granted to the trust protector, the document can specifically set forth the powers that vest in the trust protector. For sample language, see Form 3.201. The second kind of clause would simply substitute the trust protector for the trustee in the clause set forth in paragraph § 3.03[9][d].

[f] Scope of Authority

If the drafter of the trust elects to give a party the authority to modify the instrument, consideration must be given to what can be modified and the impact of the authority to modify on both the beneficiary and the trust.

The clause set forth in Form 3.201 gives the trustee the authority to modify the trust under certain specified circumstances. The underlying rationale of the grant of authority is set forth to guide both the trustee and any judicial interpreter of the instrument.

On the other hand, there may well be situations where a broader grant of authority would be appropriate. For example, if a SNT is being established for a young child whose ultimate prognosis is unknown, but at the time of establishment of the trust is

¹¹ Restatement 3d § 2, Comment b.

greatly in need of services public benefits can supply, the drafter may want to authorize the trustee to liberalize the distribution provisions to take into account improvements in the beneficiary's condition or advances in medical or other therapies. In such cases, the drafter should exercise caution so as not to create too much flexibility which might lead to an attack on the trust as being available to the beneficiary by virtue of the trustee's authority.

Further, where the trustee is a remainder beneficiary, care should be exercised in not granting so much authority to the trustee to modify the trust that it can be argued that there has been a merger¹² or the creation of a general power of appointment which would subject the trust corpus to taxation in the trustee/remainder beneficiary's estate.¹³ In reality, this particular problem is more likely to occur in termination situations than in modification situations.

Finally, another alternative is to give a party the right to remove and replace the trustee. While this does not give that party or the trustee the power to modify the terms of the trust per se, it does give the party a strong element of control over the conduct of the trustee.

[g] Modification By Court

Where the trust is silent on the subject of modification, statutes frequently offer relief following the Restatement position.

For example, Florida law authorizes judicial modification of a trust under certain circumstances:

737.4031 Judicial modification of trusts.—

(1) If the purposes of a trust have been fulfilled or have become illegal or impossible to fulfill or, if because of circumstances not known to or anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of a material purpose of the trust or, if a material purpose of the trust no longer exists, upon the application of a trustee of the trust or any beneficiary a court at any time may modify the terms of a trust which is not then revocable to:

- (a) Amend or change the terms of the trust, including terms governing distribution of the trust income or principal, or terms governing administration of the trust;
- (b) Terminate the trust in whole or in part;
- (c) Direct or permit the trustee to do acts that are not authorized or that are prohibited by the terms of the trust; or
- (d) Prohibit the trustee from performing acts that are permitted or required by the terms of the trust.

¹² See Restatement of Trusts 3d § 69: "If the legal title to the trust property and the entire beneficial interest become united in one person, the trust terminates."

¹³ IRC §§ 2041(a)(2) and 2514(b). A general power of appointment is any power possessed by the donee to appoint assets in favor of the donee, the donee's creditors, the donee's estate or the creditor's of the donee's estate.

(2) Upon the application of a trustee of the trust or any beneficiary, a trust which is not then revocable may be modified at any time by a court as provided in subsection (1), and without regard to the reasons for modification provided in subsection (1), if compliance with the terms of the trust is not in the best interest of the persons having a beneficial interest in the trust.

(a) The court shall exercise its discretion to order a modification of the trust under this subsection in a manner that conforms to the extent possible with the intention of the settlor, taking into account the current circumstances and best interests of the beneficiaries.

(b) This subsection shall not apply to a trust created prior to January 1, 2001.

(c) This subsection shall not apply to a trust created after December 31, 2000, if:

1. Under the terms of the trust, all beneficial interests in the trust must vest or terminate within the period prescribed by the rule against perpetuities in s. 689.225(2), notwithstanding s. 689.225(2)(f).

2. The terms of the trust expressly prohibit judicial modification.

(d) Modification of a trust, as authorized in this subsection, is not prohibited by a provision in the trust instrument that prohibits amendment or revocation of the trust if the provision does not expressly prohibit judicial modification.

(3) In exercising its discretion to order a modification of a trust under this section, the court shall consider the terms and purposes of the trust, the facts and circumstances surrounding the creation of the trust, and extrinsic evidence relevant to the proposed modification.

(4) To the extent the interests of any person with a beneficial interest in the trust who is unborn or unascertained, whose identity is not then known for any reason, or who is a minor or under a legal disability are not represented by another beneficiary, such person shall be represented by the person's legal guardian, if any, or, if none, by a guardian ad litem appointed by the court upon the court's own motion or upon application by the trustee or any beneficiary.

(5) The court shall consider spendthrift provisions as a factor in making a decision whether to modify a trust under this section, but the court is not precluded from exercising authority to modify the trust because the trust contains spendthrift provisions.

(6) For purposes of this section:

(a) "Beneficiary" means:

1. All current income or principal beneficiaries, whether the beneficiaries' beneficial interests are discretionary or mandatory.

2. All reasonably ascertainable beneficiaries if all current income interests immediately terminated, determined as if any power of appointment over the trust assets were not exercised.

(b) "Trust" means trust as defined in s. 731.201.

(c) A trust is revocable if revocable by the settlor alone or in conjunction with any other person. A trust is not revocable for purposes of this section if revocable by the settlor only with the consent of all persons having a beneficial interest in the property.

(d) A trust which is revocable shall be treated as created when the right of revocation terminates.

(7) The provisions of this section are in addition to, and not in derogation of, rights under the common law to modify, amend, or revoke trusts.¹⁴

Similarly, California law provides:

(a) Except as provided in subdivision (b), if all beneficiaries of an irrevocable trust consent, they may compel modification or termination of the trust upon petition to the court.

(b) If the continuance of the trust is necessary to carry out a material purpose of the trust, the trust cannot be modified or terminated unless the court, in its discretion, determines that the reason for doing so under the circumstances outweighs the interest in accomplishing a material purpose of the trust. Under this section the court does not have discretion to permit termination of a trust that is subject to a valid restraint on transfer of the beneficiary's interest as provided in Chapter 2 (commencing with Section 15300).¹⁵

Sample petitions appear as Forms 3.203 and 3.204.

[h] Modification By Statute

Where the beneficiaries and/or the grantor of the trust are still alive, some state statutes provide a non-judicial method of modification where all parties concur.

For example, California law provides:

(a) If the settlor and all beneficiaries of a trust consent, they may compel the modification or termination of the trust.

(b) If any beneficiary does not consent to the modification or termination of the trust, upon petition to the court, the other beneficiaries, with the consent of the settlor, may compel a modification or a partial termination of the trust if the interests of the beneficiaries who do not consent are not substantially impaired.

(c) If the trust provides for the disposition of principal to a class of persons described only as "heirs" or "next of kin" of the settlor, or using other words that describe the class of all persons who would take under the rules of intestacy, the court may limit the class of beneficiaries whose consent is needed to compel the modification or termination of the trust to the beneficiaries who are reasonably likely to take under the circumstances.¹⁶

¹⁴ Fla. Stat. § 737.4031.

¹⁵ Cal. Prob. Code § 15403.

¹⁶ Cal. Prob. Code § 15404.

Likewise, Florida law provides:

(1) A trust which is not revocable may be modified at any time after the settlor's death, upon the unanimous agreement of the trustee and all beneficiaries of the trust, to:

(a) Amend or change the terms of the trust, including terms governing distribution of the trust income or principal or terms governing administration of the trust;

(b) Terminate the trust in whole or in part;

(c) Direct or permit the trustee to do acts that are not authorized or that are prohibited by the terms of the trust; or

(d) Prohibit the trustee from performing acts that are permitted or required by the terms of the trust.

(2) This section shall not apply to any trust for which a charitable deduction is allowed or allowable under the Internal Revenue Code until the termination of all charitable interests in the trust.

(3) An agreement to modify a trust under this section shall be binding upon a person with a beneficial interest in the trust who is unborn or unascertained, whose identity is not then known for any reason, or who is a minor or under a legal disability, to the extent that his or her interest is represented by another beneficiary having the same or greater quality of beneficial interest in the trust, but only to the extent there is no conflict of interest between such person and such beneficiary or among the persons represented.

(4) To the extent the interests of any person having a beneficial interest in a trust who is unborn or unascertained, whose identity is not then known for any reason, or who is a minor or under a legal disability are not represented by a beneficiary under subsection (3), such person shall be represented by the person's legal guardian if there is one or, if the person does not have a legal guardian, such person shall be represented by a guardian ad litem appointed by the court upon application by the trustee or any beneficiary. Unless the court requires otherwise, the guardian ad litem's decision whether to consent to modify the trust shall be binding upon any person represented by the guardian ad litem without seeking court approval.

(5) This section shall not apply to a trust created prior to January 1, 2001.

(6) This section shall not apply to a trust created after December 31, 2000, if, under the terms of the trust, all beneficial interests in the trust must vest or terminate within the period prescribed by the rule against perpetuities in s.689.225(2), notwithstanding s. 689.225(2)(f), unless the terms of the trust expressly permit modification under this section.

(7) Modification of a trust as authorized in this section is not prohibited by a spendthrift clause, or by a provision in the trust instrument that prohibits amendment or revocation of the trust.

(8) For purposes of this section:

(a) "Beneficiary" means:

1. All current income or principal beneficiaries, whether the beneficiaries' beneficial interests are discretionary or mandatory.

2. All reasonably ascertainable beneficiaries if all current income interests immediately terminated, determined as if any power of appointment over the trust assets were not exercised.

(b) "Trust" means trust as defined in s. 731.201.

(c) A trust is revocable if revocable by the settlor alone or in conjunction with any other person. A trust is not revocable for purposes of this section if revocable by the settlor only with the consent of all persons having a beneficial interest in the property.

(d) A trust which is revocable shall be treated as created when the right of revocation terminates.

(9) The provisions of this section are in addition to, and not in derogation of, rights under the common law to modify, amend, or revoke trusts.¹⁷

Note that under the Florida statute, modification is not permitted for instruments created after December 31, 2000 where the instrument contains a "perpetuities savings clause" unless there is a specific reference in the instrument permitting modification under the Code section.

In the authors' opinion, statutes that permit modification (or even termination) of irrevocable trusts, regardless of whether the document authorizes such modification or termination, are double-edged swords. On the one hand, the statute creates a safety-valve or escape hatch enabling the parties to continually customize the document to cope with changing circumstances—a laudable goal. On the other hand, however, it could be argued that statutes that permit such all encompassing modification, such as California's, in fact create documents that are not truly irrevocable or unmodifiable and as a result a state agency could theoretically seek to compel a trustee or grantor to modify the document to require distribution to the beneficiary or take the position that since the trustee or grantor *could* undertake such action the trust in fact is an available resource. The obvious argument against this position is that such an action by the trustee would constitute a breach of the trustee's fiduciary duty to the beneficiary. However, when faced with statutory language such as Florida's which permits the trustee and all beneficiaries to "direct or permit the trustee to do acts that are not authorized or that are prohibited by the terms of the trust,"¹⁸ it gives one pause.¹⁹

[i] The Ultimate Modification Solution

ACTEC Fellow Alan S. Acker, in an article entitled *Fixing Broken Irrevocable*

¹⁷ Fla. Stat. § 737.4032.

¹⁸ Fla. Stat. § 737.4032(c).

¹⁹ For an excellent discussion of Florida-specific issues regarding trust modification, see Mary Alice Jackson, CELA *Fixing Problems: Florida Specific Issues*, in Stetson University College of Law Special Needs Trusts V (Oct. 2003).

Trusts,²⁰ posits a fascinating suggestion: “Do what you want to do anyway.” Acker cites Section 1009 of the Uniform Trust Code which provides, inter alia, that a trustee is not liable to a beneficiary for breach of trust if the beneficiary: (1) consented to the trustee’s conduct that constituted the breach; or (2) ratified the transaction which constitutes the breach or released the trustee from liability, unless the consent, release or ratification by the beneficiary was induced by improper conduct of the trustee at the time of the consent, release or ratification, or the beneficiary did not know of the beneficiary’s rights or of the material facts relating to the breach.

Acker takes the position that if all material purposes of the trust have been satisfied, the beneficiary can compel distribution. Under this scenario, the trustee is merely acceding to the direction of the beneficiary, and the beneficiary cannot hold the trustee liable for a breach of trust if the beneficiary consented to it.

This approach is both creative and gutsy. However, counsel advising the trustee needs to ask whether or not he or she would be willing to put his or her client, as trustee, in the position of making a distribution under these circumstances, regardless of how ironclad one felt the release was framed. That said, it is certainly an approach worth considering when all else fails.

²⁰ Allen Acker, *Fixing Broken Irrevocable Trusts*, 31 ACTEC J. 221, 230 (2005).
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CHAPTER 3

Sources of Assets to Establish Special Needs Trusts

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