Planning for Clients with Special Needs

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Planning for Clients with Special Needs

Chapter One
Introduction to Planning for Clients with Special Needs

(NOTE: Throughout these materials, all references to "Code Section" or "Section" are references to a section of the Internal Revenue Code of 1986 ("IRC" or "Code"), as amended. All references to the Probate Code are references to the California Probate Code.)

Section 1.01 The Concept of "Special Needs Planning"

Clients with disabilities (and their families) face the same planning issues, concerns and challenges as most other clients. That is, they need the right estate planning documents to protect them and their assets, but modified to address their disability and tailored to their circumstances. Conceptually, think of it as traditional estate planning "with a twist."

Planning for clients with special needs is both challenging and immensely rewarding. The planning itself is challenging because it's often necessary to navigate a complicated web of rules and regulations to achieve the desired results. At the same time, a primary goal is preserving a person's access to government benefits while enhancing his or her quality of life. For example, as discussed later in this course, utilizing a "special needs trust" is an excellent way to allow access to funds to pay for a person's supplemental expenses not covered by government benefits.

Section 1.02 Why Proper Planning is Critical

Proper planning provides peace of mind and protection against legal, financial and other problems. It's about avoiding the common pitfalls that may happen without adequate preparation.

Planning for a client with special needs requires foresight, expertise in a variety of disciplines and attention to detail. Another key planning goal is to put systems in place that will stand the test of time and enhance the client's quality of life.

For example, suppose a 14-year old child named Susan has a severe and permanent physical disability. It's foreseeable that this condition will require some assistance during her remaining lifetime. If Susan lives a normal lifespan, this could be another 70 years or more. Thus, the challenge lies in designing a trust (if that is the proper solution) which is flexible enough to adapt to changes in Susan's level of care and keep her eligible for services which provide her support. Another planning objective is ensuring that the trust would last for Susan's lifetime. Thus, the budget portion of the trust's distribution plan should have a rate of return and rate of distributions to last the beneficiary's lifetime.

Additionally, a properly drafted special needs trust can include systems for sustained care and advocacy to last beyond the settlor's lifetime.

Section 1.03 Planning Scenarios

Consider the following fact patterns which are common in the world of planning for clients with special needs.

(a) The $100,000 Inheritance "Problem"

Your client Janice, age 35, calls to inform you that her mother passed away and she is the beneficiary of mom's life insurance policy. Janice receives Supplemental Security Income (SSI) and Medi-Cal. Janice has been renting an apartment but may want to use the life insurance proceeds to purchase a home. The client's objectives are keeping her public benefits and minimizing administrative costs. What choices does Janice have to achieve her goals?

The answer may largely depend on the amount of assets, but if Janice has a living parent or grandparent, he or she can be the settlor of a "first party" special needs trust to be funded by the insurance proceeds. In addition, with the enactment of the 21st Century Cures Act on December 13, 2016, Janice herself, assuming she has capacity, can establish her own self-settled special needs trust. This new law includes the Special Needs Trust Fairness Act, allowing competent individuals with disabilities to create their own special needs trusts.

Alternatively, perhaps Janice has previously appointed an attorney-in-fact, acting under a power of attorney, who would be authorized to establish the special needs trust. Section 1.06 discusses alternatives to creating a first party special needs trust that may meet Janice's goals.

Probate Code §§ 3410–13 provide for the disposition of funds belonging to a minor, other than funds disposed of under Probate Code §3602 (dealing with compromise of a minor's claim). Under the provisions of Sections 3412–13, on petition to the court by the parent or guardian, the funds can go to a guardianship account, a blocked account, or a custodianship account established under the Uniform Transfers to Minors Act.

(b) Litigation Settlement

A 14-year old child with a disability who was injured by a defective product obtains a settlement from a pending lawsuit. The child receives Medi-Cal and will be eligible to receive SSI payments when she turns eighteen. What are the options for receiving the settlement funds?

One option in personal injury cases is a "structured settlement." This arrangement provides annuity funded income tax favored payments for the person's lifetime or a term of years.

Another option is to create a qualifying first party special needs trust. This is the primary way to preserve public benefits for a litigation recovery. In addition, combining a structured settlement with a special needs trust can be an effective way to provide for the beneficiary's future needs.

Section 1.04 The Unique Challenges of Special Needs Planning

Planning involves several specialty areas, including estate planning, public benefits law, tax planning, family law and incapacity planning.

There are complex laws and regulations to understand and interpret at the federal and state levels. In addition, when court intervention is required, the attorney must comply with the local rules of court (e.g., with a court established special needs trust for a minor).

Parents with special needs children and typical children face the question of how to distribute their estate. This is an individual family decision and there are no "right" answers. It may be appropriate to allocate a larger portion of the estate to a child with a disability because additional resources will be required to maintain a proper level of care and support throughout the person's lifetime.

Section 1.05 Team Approach

Particularly in the case of special needs planning, no one professional has all the answers. Diverse skills and experience are necessary for the best results. The team approach is generally more efficient, thereby minimizing time and costs. With everyone involved from planning through implementation, they can work together and hold each other accountable.

At a minimum, the advisory team will likely include an estate planning attorney who is knowledgeable about public benefits law, accountant and financial advisor. In addition, a professional trustee, care manager, trust protector and/or trust advisory committee may be involved in the planning and implementation. If the person with a disability is not receiving certain benefits, no special planning may be necessary. Thus, as a threshold matter, the advisory team must recognize which benefits, if any, that the person with a disability is receiving.

Section 1.06 Alternatives to First Party Special Needs Trusts

(a) Spend down

If the amount of the excess resources is relatively small (e.g., a modest inheritance), it might make more sense to spend the money rather than to incur the set-up and ongoing administration costs associated with a special needs trust. A "spend down" strategy could also be a strong option where the beneficiary has a current need for more expensive items such as a home, a modified vehicle, or even to pay off debt. Spending for these items would not be possible if the beneficiary were to rely solely on public benefits.

(1) Timing is Crucial

Ideally, there should be a plan in place prior to receiving a lump sum. In order to minimize the loss of SSI and Medi-Cal, goods and services must be purchased in the same calendar month in which the lump sum is received. Note that the individual does not have a period of a month or 30 days to complete the "spend down." For example, if a lump sum is received on the 20th of August, the "spend down" must be

completed in 11 days to bring resources below the applicable limit before September 1st.

(2) When to Report

The "spend down" must be reported to Social Security by the 10th day of the month following the month in which the lump sum was received.

(b) Gifting to a Family Member

Can the individual transfer or disclaim assets? Yes, but a gift results in a period of ineligibility.

If the person receiving benefits makes a qualified disclaimer of an inheritance, will this solve the problem? Unfortunately, both the SSA and Department of Health Care Services (DHCS) take the position that a qualified disclaimer of an inheritance results in a transfer penalty (See Section 2.05).

(c) Purchase "Exempt" Assets

The following is a non-exhaustive list of exempt expenditures that the lump sum recipient could make and still qualify for SSI:

- Purchasing a home; paying off a mortgage on a home; paying rent for that calendar month only; modifying a home to accommodate an individual's disabilities; home repairs, remodeling, or deferred maintenance expenses (including landscaping)
- Purchasing home furnishings or appliances
- Medical expenses/bills not covered by Medicaid or Medicare (e.g., better quality wheelchair than what is authorized by Medicaid/Medicare)
- Dental expenses, eye glasses, physical therapy, support services not covered by any benefit program
- Education expenses (including computer, software, books, etc.)
- Entertainment and recreation expenses (books, magazines, movie/concert tickets, sporting events, audio/video equipment)
- Vacation travel (airline tickets, train/bus passes, food and shelter while temporarily away from home on vacation, etc.)
- Pay an attorney to do estate planning and/or Medicaid planning
- Pay off debts (existing credit card debt, loans with supporting paperwork)
- Pre-pay burial arrangements
- Personal hygiene (haircuts, manicures)

- Purchase an automobile, pay for registration and insurance
- Purchase clothing
- Set aside up to $2,000 for a single person, or up to $3,000 for a married couple, in non-exempt resources, e.g., in savings, checking, etc.

(d) Do Nothing

One option is to keep the assets and forfeit benefits until resource limits are satisfied.

(e) Trust Modification

Most courts are sympathetic to the situation of a trust beneficiary with a disability and on public benefits but for whom the settlor has provided either a support trust or a direct distribution from the trust. Timing is of the essence in this case because action is needed prior to a distribution from the trust to the beneficiary.

Under Probate Code §15403, "if all beneficiaries of an irrevocable trust consent, they may compel modification or termination of the trust upon petition to the court," if a material purpose of the trust is not impaired by the termination or modification. This provision permits a court petition, supported by the consents of all beneficiaries, explaining that the settlor wished to provide for his or her issue in a reasonable, prudent manner, and that to make an outright gift to a child, or make a distribution to a support trust that could be considered available to the beneficiary, would thwart the settlor’s intent. The relief sought includes modification of the trust to include a special needs provision for the beneficiary with a disability.

Probate Code §15409 permits modification of a trust "On petition by a trustee or beneficiary, . . . if, owing to circumstances not known to the settlor and not anticipated by the settlor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust." This provision may be utilized in other circumstances, e.g., the settlor was unaware that the beneficiary was receiving government assistance, or the disability arose after a time when the settlor could have changed her trust.

Some practitioners use both statutory provisions to support a trust modification. In either case, it helps to furnish what anecdotal information is available about the settlor and the relation of the settlor to the beneficiary. The advantage to proceeding this way, rather than have the beneficiary receive the inheritance and establish a first party trust, is that reformation of the existing trust instrument permits you to establish a more flexible third party trust with no “payback” requirements to the state.

Chapter Two
The Complex World of Public Benefits

Public benefits can serve an important role for people with special needs and/or limited resources. People with special health care needs and limited funds of their own often rely on public benefits for their well-being. In planning for clients with special needs, some of the most common public benefits include Supplemental Security Income (SSI), administered by the Social Security Administration, and Medicaid, administered separately in each state. Medi-Cal is California's Medicaid health care program. To be eligible for SSI and/or Medicaid, an individual usually is limited to $2,000 in resources (or $3,000 for a couple).

According to the SSA, Medicaid is a jointly funded, federal-state health insurance program for low-income and needy people. It covers children, the aged, blind, and/or disabled and other people who are eligible to receive federally assisted income maintenance payments.

Because the resource limits for SSI and Medicaid are so low, the receipt of a lump sum, including an inheritance or a settlement, can easily disqualify the individual. Upon the receipt of sums in excess of the resource limits, the individual can opt to discontinue benefits, shelter the excess amounts in certain types of special needs trusts, or attempt to re-qualify for benefits through a process known as a "spend down" as described in Chapter One.

Section 2.01 Qualifying for Public Benefits

The most common programs which involve special needs planning are described below:

(a) Supplemental Security Income (SSI)

SSI provides a modest cash allowance for food and shelter. To qualify, a person must be age 65 or older, blind or disabled (i.e., unable to do any substantial gainful activity); comply with limitations for earned income, unearned income and resources to pay for food and shelter; establish residency and prove citizenship or qualifying alien status.

In California, a person's SSI monthly cash payment consists of the federal government payment (Federal Benefit Rate or FBR) and state's contribution (State Supplementary Payment or SSP). For 2019, the FBR is $771 for an individual and $1,157 for a couple. The SSP in California is $160.72 for an individual and $407.14 for a couple. Thus, combined with the Federal Benefit Rate of $771, this allows an individual a total benefit of $931.72. The maximum benefit for a couple is $1,564.14.

(b) Medi-Cal

A person can become eligible for Medi-Cal in several ways. Under the concept of "categorical eligibility," if an SSI beneficiary receives at least $1 of SSI, the beneficiary receives full-scope Medi-Cal automatically. Other ways to become eligible are through the Aged and Disability Federal Poverty Level program; the Aged, Blind and Disabled (also called

"medically needy" or "share of cost" Medi-Cal) program and various Medi-Cal waivers (e.g., DDS Home and Community-Based Waiver also known as the "Institutional Deeming Waiver" and Nursing Facility/Acute Hospital Waiver Program).

(c) In-Home Supportive Services (IHSS)

This program provides people with disabilities or who are over age 65 with in-home and personal care services to help them safely live in their home or maintain an independent living arrangement. IHSS is considered an alternative to out-of-home care, such as nursing homes or board and care facilities.

Some of the services that can be authorized through IHSS include: housecleaning, meal preparation, laundry, grocery shopping, personal care services (such as bowel and bladder care, bathing, grooming and paramedical services), accompaniment to medical appointments, and protective supervision for the mentally impaired.

Section 2.02 Determining the Type of Benefit

Public benefits like SSI and Medi-Cal provide the recipient with basic needs for food, shelter and medical care. However, as described in Section 2.03, there are strict income and asset requirements of the SSI and Medi-Cal programs.

As a threshold matter, the practitioner must determine from which government benefit program the person currently receives or is likely to receive future benefits. *It's very important to collect accurate information and not rely solely on information provided by the client.*

Identifying the type of benefit an individual receives is critical to proper planning, and yet is often difficult. The most common programs have similar sounding names e.g., Supplemental Security Income (SSI) and Social Security Disability Insurance (SSDI). Confusion is common between SSI and Social Security benefits because both monthly payments come from SSA and may be direct deposited into the client's bank account.

SSI provides a monthly cash payment for food and shelter. Medi-Cal funds a variety of medical treatments and is the government program most often used for long-term nursing care. As described below, these are "needs based" programs.

SSDI pays a monthly benefit to individuals with disabilities who have a sufficient work history.

There are two basic categories of public benefits: needs-based (sometimes referred to as "means tested") benefits and entitlement benefits.

(a) Needs-based

These public benefit programs have strict income and asset limitations for eligibility and include SSI, Medi-Cal, housing subsidies (Section 8) and IHSS.

Medicaid (Medi-Cal in California) is a combined federal and state program designed to help pay for public assistance recipients and other low-income persons. This program offers medical benefits to certain individuals such as older adults, persons with disabilities and those who receive public benefits (e.g., SSI).

Under the Patient Protection and Affordable Care Act (ACA) (Public Law 111-148), California has expanded its Medi-Cal program. As a result and effective January 1, 2014, adults under age 65 with family income below 138 percent of the Federal Poverty Level may enroll in Medi-Cal, regardless of disability status and without any asset test.

(b) Entitlements

Entitlement benefits are available to eligible individuals, regardless of income or resources. The main entitlement programs are Social Security Retirement Benefits, Social Security Disability Insurance (SSDI), Social Security Family Member and Survivor's Benefits and Medicare.

Section 2.03 What Are the Resource and Income Limitations?

In general, the resource test determines eligibility and the income test determines how much a person receives.

(a) Resource

A "resource" means cash or other property which an individual could access and convert to cash. There are "exempt resources" and "countable resources" (i.e., the total amount of nonexempt assets). If resources exceed the limits on the first *moment* of the first day of the month, the recipient is not eligible for that month and may have to repay amounts overpaid. Then, the person would remain ineligible for future months until the assets fall below the required limits.

(1) SSI

An individual who receives SSI is only entitled to $2,000 in nonexempt (countable) resources ($3,000 for an eligible couple). Thus, a second automobile or vacation home would cause an individual to lose SSI until the assets are spent down to less than $2,000.

According to the SSA's Program Operation Manual System (POMS), a trust is a legal arrangement involving property and ownership interests. Property held in trust may or may not be considered a resource for SSI purposes.

(2) Medi-Cal

To qualify for traditional Medi-Cal benefits, an individual cannot have more than $2,000 in "countable" assets ($3,000 for a couple). On the other hand, eligibility for expanded Medi-Cal under the ACA depends on the applicant's

"modified adjusted gross income" which must be below 138 percent of the federal poverty limit. There is no asset limitation under expanded Medi-Cal.

(b) Income

(1) SSI

There is a very low income ceiling for SSI. Income is treated as either "earned" or "unearned."

(a) Earned Income

Some examples include wages, net earnings from self-employment, payments for participating in a sheltered workshop or work activity center, royalties for publication of the individual's work and honorariums.

(b) Unearned Income

This refers to everything other than "earned income." Thus, this category includes "in-kind support and maintenance" or "ISM" (described below), private pensions and annuities, periodic payments such as SSDI, worker's compensation, veterans benefits and unemployment, life insurance proceeds, gifts and inheritances, support and alimony, prizes and awards, dividends and interest, rents and royalties.

(c) Exclusions

Certain items are not treated as income, such as the first $20 of any income in a month (except ISM); $65 of earned income; half of the remaining earned income in a month; and the first $780 per year for a person with a disability.

Cash distribution to an SSI recipient (or reimbursement) is treated as "unearned income" which will reduce the benefit dollar for dollar (after the first $20 of unearned income).

Thus, receiving unearned income would result in a larger reduction to a person's SSI payment than earned income.

(d) Deeming Rules

In some cases, SSA will consider the income and/or resources of another person in determining a person's eligibility for benefits. This process is called "deeming."

> In the most common situation, resources and income from a parent will be "deemed" to a minor child who is living with his or her parents. Thus, a child's resources are deemed to include the resources of parent which exceed the parents' resource allowance. Similarly, SSA will count some of the income of parents in determining a child's SSI eligibility and amount.

There is a special category of SSI unearned income dealing with payments for food and housing referred to as "in-kind support and maintenance." ISM can reduce the recipient's benefit depending on the person's living situation.

ISM means food or shelter provided directly to the recipient or paid for by a third party. If an individual receives ISM, his or her SSI is reduced. The reduction formula depends on the person's living situation.

There are two rules to place a value on ISM: Value of One-Third Reduction (VTR) or Presumed Maximum Value Rule (PMV). VTR is sometimes called "living in the household of another."

VTR applies when a benefits recipient lives throughout a month in another person's household and receives **both** food and shelter from others living in the household. Based on the eligible individual receiving both food and shelter from the household and not paying his pro rata share, he is subject to the VTR.

The PMV rule applies in all other cases. For example, it applies when a special needs trust trustee (or any third party) pays a third party for a beneficiary's food or shelter costs. In this case, the payment counts as ISM, it must be reported to the Social Security office, and leads to a reduction in SSI. If the amount paid for food or shelter was less than the "presumed maximum value," which for 2019 is $277, the SSI will be reduced by the amount paid for food or shelter. If the amount paid for food or shelter was $277 or more, the reduction will be limited to $277. The "presumed maximum value" approach applies to individuals who live in their own households or are living in non-institutional care situations or group homes.

(2) Medi-Cal

There is no income limit for traditional Medi-Cal. However, unless the person qualifies under the "categorically needy" classification, a "share of cost" (SOC) will apply before Medi-Cal will pay for any remaining medical costs. Think of the SOC like an insurance deductible.

Section 2.04 Exempt Resources

(a) SSI

The following assets are excluded for purposes of SSI eligibility:

- Principal residence (of any value)
- One automobile (of any value) used for transportation of the applicant or a member of the applicant's household
- Household items and personal effects
- Burial insurance and funds set aside for burial expenses
- Life insurance policies with cash surrender value, if total face values are less than $1,500 and all term life insurance
- Certain property essential to self-support used in a trade or business
- The work-related pension plan of an applicant's spouse

(b) Medi-Cal

The following property is generally exempt and not counted in determining eligibility:

- Principal residence. The applicant must state an "intent to return to the home." This includes mobile home, houseboat, or an entire multi-unit dwelling as long as any portion serves as the principal residence of the applicant.
- Household goods and personal effects
- Jewelry: for a single person, wedding, engagement rings and heirlooms, and items of jewelry with a net market value of $100 or less are totally exempt; for spouses, there is no limit on exempt jewelry for determining the institutionalized spouse's eligibility.
- One automobile (of any value) used for transportation of the applicant or a member of the applicant's household
- Whole life insurance policies with a total face of $1,500 or less
- Term life insurance of any amount
- Burial plots including headstone, crypts, etc.
- Prepaid irrevocable burial plan of any amount and $1,500 in designated burial funds
- Cash surrender value or balance of pension funds, IRAs and certain types of annuities

Section 2.05 Transfer Penalties

There is a penalty for transferring assets without receiving fair value in return (e.g., gifts and/or sales of property for less than fair market value). The penalty refers to a period of ineligibility for SSI and/or Medi-Cal long-term benefits. These rules are designed to discourage people from giving away assets to qualify for benefits.

(a) SSI

People who transfer assets for less than fair market value on or after the "look back" period are ineligible for SSI up to 36 months. The look-back period is also 36 months and starts from the date of the application or transfer, whichever is later.

To calculate the period of ineligibility, divide the amount transferred by the recipient's monthly SSI benefit, rounding the answer up or down to the nearest whole number.

EXAMPLE: Sam is receiving the maximum SSI benefit ($931.72/month in 2019) and gets a $25,000 inheritance from his aunt. Sam transfers the entire inheritance to his daughter. Sam would lose his SSI benefit for 27 months (25,000/931.72 = 26.83, rounded up to 27 months).

(b) Medi-Cal

While the purpose of the Medi-Cal transfer penalties is to discourage people from transferring nonexempt assets to qualify for benefits, they only apply to Medi-Cal for nursing home care or similar institutional care services under the current rules. Thus, the Medi-Cal application asks if the applicant transferred any assets within the 30 months prior to the date of the application.

If a person transfers assets for less than fair market value on or after the look-back date (currently 30 months), there is a period of ineligibility for long-term care Medi-Cal benefits. The period is calculated by dividing the amount transferred by the statewide "average private-pay rate" (APPR) for nursing facility services. The 2019 APPR in California is $9,337.

EXAMPLE: Mark transfers $15,000 to his son in January 2019 and applies for Medi-Cal in February 2019. Because Mark is in a nursing home, a transfer period will be triggered. The amount transferred ($15,000) is divided by the 2019 APPR ($9,337), resulting in a period of ineligibility of 1.6 months. California does not count partial months and, therefore, Mark will be ineligible for one month, running from the month of transfer (January 2019) but he will be eligible as of February 1, 2019.

PRACTICE POINTER: Note that in California, transfers to different individuals are calculated *separately* and not aggregated with other transfers. In other words each gift triggers its own period of ineligibility and can run concurrently with others. As a result, if a transfer is split into two parts (e.g., $10,000 each to an individual's two children), two shorter

periods of ineligibility run simultaneously and, therefore, the total period of ineligibility will be cut in half.

Section 2.06 Medi-Cal Estate Recovery

What is Medi-Cal estate recovery (sometimes referred to as the "Medi-Cal lien")?

This is an unsecured claim made by Medi-Cal against the recipient's estate for recovery of lifetime medical benefits paid to the recipient. For example, the home may be an exempt asset while a person is alive and is not counted for Medi-Cal eligibility purposes. However, if the home is still in your name at death, the State of California can make a claim against your estate for the amount of the Medi-Cal benefits paid or the value of the beneficiary's estate, whichever is less. Thus, if your home or any part of it is still in your name when you die, it is part of your "estate" and can be subject to an estate claim. California's definition of "estate" includes such assets as living trusts, joint tenancies, tenancies in common and life estates, but new rules applied beginning on January 1, 2017 (see below).

For example, if the appraised value of your home is $400,000 and you left it in joint tenancy with your three children, the State can only collect up to $100,000, which is your part of the estate, even if the Medi-Cal benefits paid to you exceeded $100,000. The value of the estate is also reduced by any outstanding mortgages or debts on the home.

(a) New Rules Effective January 1, 2017

For individuals dying on or after January 1, 2017, there are significant changes to the Medi-Cal recovery program rules. The new law includes the following favorable provisions:

- Eliminates recovery on estates of surviving spouses and registered domestic partners.
- Limits recovery for those age 55 and older to nursing home and Home and Community Based Services.
- Prohibits recovery from assets held in a living trust or transferred by joint tenancies, so that recovery is limited to California probate assets.
- Requires DHCS to waive its claim when property subject to recovery is a homestead of modest value (i.e., a home valued at 50 percent or less of the average price of homes in the county where the homestead is located).

Section 2.07 Notification to Social Security Administration

A benefits recipient must report any changed circumstances that may affect SSI as soon as possible and no later than 10 days after the end of the month in which the change occurred. For example, a person should inform SSA of changes in income, resources or living arrangements and the establishment of a special needs trust, if applicable. Failure to report these changes could result in sanctions against the benefit payments.

Chapter Three
Estate Planning Issues

As the number of persons with disabilities in the United States continues to increase, clients frequently need to provide for other family members as part of their own estate planning. Public benefits such as SSI and Medi-Cal cover a basic level of food, shelter and medical care, but leave gaps for those in need of supplemental goods and services. Thus, the challenge lies in determining which estate planning strategies to utilize in a particular case. This chapter will explore the common issues facing these clients and offers a number of potential solutions.

Section 3.01 Working Definition of Estate Planning

"I want to control my property while I'm alive, take care of me and my loved ones if I become disabled, and give what I have, to whom I want, the way I want, and when I want. Furthermore, if I can, I want to save every last tax dollar, professional fee, and court cost legally possible."

Estate planning typically involves a higher level of complexity when a person with a disability becomes part of the equation. In addition, the benefits of good planning are significant and the problems resulting from a failure to plan can be devastating.

The benefits of proactive estate planning in this scenario include the following:

- The ability to keep needs-based public benefits
- Appropriate financial and asset management
- Identifying individuals and/or corporate fiduciaries to administer a gift or inheritance
- Articulating standards for advocacy and personal care
- Provide direction for the beneficiary's living arrangements
- Direction for assets following the beneficiary's death

On the other hand, a lack of planning can lead to loss of important public benefits, requiring first party planning (which may be more complicated and costly), undue influence and wasting assets. Further, failure to plan can result in strained family relations and family members being overwhelmed by mounting responsibilities.

Section 3.02 Proactive Estate Planning

If the person with a disability has capacity to sign documents and take informed planning steps, then the client should proceed with his or her estate planning. For example, a properly drafted revocable living trust solves the problem of asset management if the person becomes incapacitated. The client names an individual (or professional trustee) to manage the assets if he or she is unable to perform these tasks. Equally important is a durable power of attorney for financial management. Both the trust and power of attorney should authorize

your trustee and attorney-in-fact to implement Medi-Cal planning, including the power to apply for other benefits, as needed.

Every estate plan should contain a "pour over" Will to coordinate with the trust, advance health care directive and HIPAA Authorization. Finally, the drafter should consider including "standby" special needs trust provisions in the trust for any beneficiary who is entitled to a distribution and is receiving or applying for needs-based government benefits such as SSI or Medi-Cal.

A comprehensive power of attorney is important to address all potential issues, including the right to make gifts, deal with the IRS, and engage in Medi-Cal planning. In California, for an agent to act on behalf on an incapacitated grantor or beneficiary, appropriate language must be included in the trust instrument and power of attorney document. Probate Code §§4264(a) and 15401(c).

SAMPLE POWER OF ATTORNEY PROVISION

"I appoint my Attorney-in-Fact as my *Representative Payee* for the purposes of receiving Social Security benefits. My Attorney-in-Fact may collect all benefits payable to or for my benefit by any governmental agency or body, such as Supplemental Security Income (SSI), Medicaid, Medicare, and Social Security Disability Insurance (SSDI). My Attorney-in-Fact shall have the full power to represent me and deal in all ways necessary concerning rights or benefits payable to me by any governmental agency including Supplemental Security Income (SSI), Medi-Cal, and Social Security Disability Insurance (SSDI).

My Attorney-in-Fact may gift or otherwise spend down my estate for Medicaid eligibility and planning."

Section 3.03 Approaches to Estate Planning

The following discussion summarizes the options available for clients who are designing their estate plans for a family member with special needs. A related issue is how to balance the needs of the family member with a disability and those of other family members.

(a) Outright (Direct Bequest)

With an outright distribution, the beneficiary receives his or her inheritance directly, with no strings attached. There are no restrictions or protections placed on outright gifts. For a person with a disability, this can be problematic on several accounts.

An outright gift might disqualify the person from benefits or cause transfer penalties. Failure to report the inheritance can result in sanctions or, at a minimum, repayment of benefits improperly received. Perhaps a significant windfall would place an unsophisticated beneficiary at risk for undue influence from friends, family members or others.

(b) Disinheritance

This approach alleviates some of the problems mentioned above but also leaves the individual with few options other than reliance on government programs and policies. Thus, disinheritance is generally not recommended.

(c) Leaving Assets to a Family Member

This alternative involves distributing the individual's share of the estate to another family member (e.g., a sibling) with instructions to care for the person with a disability. The concerns are that such an informal ("precatory") agreement is not legally binding nor is there any assurance the donee will use the gift as planned. The donee may dissipate the funds, become incapacitated, file for bankruptcy, or get divorced, putting the assets at risk. Finally, there is the issue of family dynamics and possible strained relations resulting from such an arrangement.

(d) Support Trust

A "support" trust authorizes distributions for the beneficiary's "support or maintenance" and may represent a better option than an outright bequest, disinheritance or precatory gift. However, the support trust may be treated as a resource, resulting in a loss of SSI benefits and categorically linked Medi-Cal.

(e) Third Party Special Needs Trust

A preferred way to leave an inheritance to a person with a disability is through a third party special needs trust, providing lifetime care and advocacy for the beneficiary. This option is covered in greater detail in Chapter Four.

PRACTICE POINTER: It makes sense to advise other family members about the existence of a third party special needs trust for the purpose of lifetime gifting and/or planning for an inheritance.

(f) ABLE Act Account

The Achieving a Better Life Experience (ABLE) Act of 2014 offers individuals with disabilities another option to save money in tax-favored accounts without jeopardizing their government benefits. In many cases, ABLE Accounts can complement the use of special needs trusts. Chapter Six covers ABLE accounts in further detail.

Section 3.04 Selling Parent's Home to Pay for Nursing Home Care

Family members often wonder if it's prudent to sell a parent's home to pay for care in a nursing home. Based on the resource limitations discussed earlier, if the home is sold, the sale proceeds would likely cause the parent to exceed those resource caps. The parent would then be ineligible for benefits and rely upon those proceeds to pay the full cost of care. Over time, those funds would be spent down and, perhaps, exhausted. A better option might be to implement a specially designed trust described below.

(a) "House Trust"

If a residence is owned by a grantor trust, e.g., in a specially designed irrevocable Medi-Cal asset property trust, the income tax benefits of home ownership would continue to be available to the grantor (e.g., deduction of property taxes and Code Section 121 capital gains tax exclusion). For

Proposition 13 property tax purposes, there is no “change in ownership” and, therefore, no reassessment of the property.

Some practitioners call this a “House Trust” which is designed to preserve home sales proceeds while also preserving eligibility for government long term care benefits.

Chapter Four
First Party and Third Party Special Needs Trusts

Special needs trusts are an indispensable tool in the estate planner's toolkit. These trusts exist for two primary reasons: to enhance the person with a disability's quality of life and preserve his or her eligibility for certain government benefits. For many parents, a well-designed special needs trust is the most effective way to help their child with a disability.

Section 4.01 Special Needs Trusts At a Glance

There are two basic categories of special needs trusts (SNTs): first party ("self-settled") trusts and third party trusts. Understanding the features of each type and the circumstances under which they operate is crucial to planning. The fundamental difference between the two types of trusts is the source of funds used to fund the trust. Thus, the first question to evaluate is "Whose money was used to fund the trust?"

Despite their differences, both types of SNTs have common features. For example, the SNT trustee has sole and absolute discretion over the special needs trust's operations. Conversely, the beneficiary has no control. The legal reason for this structure is to ensure the trust won't be treated as an "available resource" for SSI and Medi-Cal purposes, which in turn would cause the beneficiary to lose his or her eligibility.

SAMPLE TRUST PURPOSE PROVISION

"*Trust Purpose.* The purpose of this trust is to provide for the special needs of the Beneficiary, a person with a disability. The Beneficiary presently suffers from a disability that substantially impairs her ability to provide for her own care and custody and constitutes a substantial handicap. The Beneficiary either receives or is entitled to receive public benefits on account of her disabilities. In general, this trust is therefore intended to supplement, and not to supplant, the public benefits that would be available to the Beneficiary if this trust did not exist.

Treatment of Trust by Public Benefit Programs. The purpose of this trust is to satisfy Supplemental Security Income ("SSI") and Medi-Cal program requirements, and this trust shall be interpreted to satisfy such requirements notwithstanding any other language herein, so that the establishment, funding, and administration of the trust do not prejudice the Beneficiary's eligibility for or ability to maximize public benefits. The purpose of the trust is to supplement and not supplant such benefits. However, the Trustee has discretion to make distributions causing some loss of benefits if the Trustee determines that doing so would be in the Beneficiary's best interests."

> **PRACTICE POINTER:** These trusts are sometimes referred to as "special needs" or "supplemental needs" trusts. As a general rule, the trust should be identified as a "special needs trust" because most Social Security Administration and Department of Health Care Services officers are familiar with this term.

(a) First Party Special Needs Trust

An individual with a disability funds a first party ("self-settled") special needs trust with his or her own assets. First party special needs trusts allow individuals to avoid spending down their own assets before qualifying for needs-based government benefits. A first party special needs trust is a federally authorized safe harbor, with two varieties based on the statutory authority for a self-settled special needs trust. 42 U.S.C. §1396p(d)(4)(A)("payback" trusts) and (d)(4)(C) ("pooled" trusts).

Typically, first party special needs trusts are created when the person with a disability receives a settlement from litigation, an inheritance or gift in his or her own name. The beneficiary may also use his or her existing assets to fund the trust.

Features of a first party special needs trust include the following:

- Beneficiary must be disabled under the SSA rules
- Beneficiary must be under age 65 when the trust is created
- A first party special needs trust must be for the "sole benefit" of the beneficiary
- The trust must be established by the person with a disability, a parent, grandparent, legal guardian or court order (sometimes referred to as "seed" trusts)
- Must contain a "payback" provision

A self-settled special needs trust most frequently is a "(d)(4)(A)" trust and is referred to that way. In addition, the trust must be an inter vivos trust, rather than a testamentary trust, and it must be irrevocable. Although the federal statute does not expressly require the trust to be irrevocable, this is a requirement of the SSA and Medi-Cal.

(1) "Seed" Trusts

A "seed trust" is a type of "(d)(4)(A)" SNT established by a parent or grandparent for the benefit of a child with a disability by funding the trust with a nominal amount of his or her own funds. Once the seed trust is established, the adult person with a disability who has capacity can transfer his own assets to the trustee of the trust.

RECENT DEVELOPMENT

On December 13, 2016, President Obama signed Federal legislation, the 21st Century Cures Act, which removed a significant barrier to creating special needs trusts. As part of this legislation, the Special Needs Trust Fairness Act allows people with disabilities to create their own special needs trusts instead of having to rely on others.

The Special Needs Trust Fairness Act fixed a drafting error in the Social Security Act that prevented people with disabilities from creating special needs trusts to hold their own funds. The Special Needs Trust Fairness Act fixed this error and specifically permits a person with disabilities to create his or her own trust. Unfortunately, the bill does not eliminate the portion of the law requiring first party special needs trusts to contain payback clauses allowing the government to recoup Medicaid costs from trust assets after the beneficiary passes away.

(b) Pooled Trusts

These trusts are also called "master trusts" and operate like a bank holding assets of individual account holders. Thus, the assets of many trusts are combined for investment purposes, but are managed individually for distribution purposes. There is a master trust document that is adopted to govern the trust. A pooled trust can be a self-settled trust or a third party trust, depending on whether the assets used to fund the trust belong to the person with disabilities or to a third party. A pooled trust is the primary option available for a person with a disability who is age 65 or over.

(c) Third Party SNT

These trusts are created by and funded with assets of someone other than the person with a disability, often by a parent for the benefit of a child with a disability. In drafting third party special needs trusts, the attorney need not be concerned with Medicare claims, Medi-Cal liens, or age limits relating to the beneficiary. Therefore, the attorney has great flexibility in structuring the trust to achieve the settlor's income, gift and estate tax planning goals.

There is no federal statutory authority for a third party special needs trust. However, SSA has policy regarding the effect of these trusts on benefits.

The purpose is to provide for a beneficiary's "special" or "supplemental" needs rather than basic needs (e.g., transportation). That said, even if preservation of benefits is not a current concern, it may make sense to implement a special needs trust. Why?

A special needs trust is a fully discretionary spendthrift trust which can offer money management and protection for a beneficiary who may be susceptible to outside influence.

A third party special needs trust must be drafted as a fully discretionary trust. This means that the beneficiary cannot compel any distributions, which are in the trustee's sole discretion. In California, third party special need trusts can be created in two ways: as a standalone special needs trust, or as a sub-trust created under a revocable living trust plan. Because the beneficiary has no right to compel trust distributions, the principal and income will not be considered an "available resource" to the beneficiary.

Thus, the trust drafter must avoid common trust terms such as "health, education, maintenance and support" (the "HEMS" standard) because to the extent the trustee could make a distribution under this standard, the trust might be considered an available resource. Also, the beneficiary should not have any power or control over the trust, such as the power to remove a trustee, require distributions or terminate the trust.

(d) Third Party Special Needs Trust for Spouse

If the settlor's spouse is the beneficiary of a third party SNT, it will be disregarded as an available resource to the spouse only if it is created under the terms of the settlor's will, and not pursuant to a revocable living trust.

(e) Standalone Trusts

Clients often ask about creating a third party SNT as a standalone trust, separate from their primary estate plan. This can be useful when there are multiple potential donors such as parents and grandparents. By paying for supplementary items currently, the family demonstrates to future trustees the types of disbursements that are appropriate to the person's needs and that have passed government scrutiny. Having a living special needs trust can create a much more secure scenario for the person with the disability.

(f) Revocable or Irrevocable

As a general rule, a standalone third party SNT should be revocable to allow for flexibility. However, if the special needs trust is going to be the beneficiary of retirement benefits, an irrevocable trust is advisable. The reason is that one of the requirements for a trust to be a designated beneficiary of a retirement plan is that it is irrevocable under state law. Thus, the trust will allow for "stretched out" payments of retirement plan benefits.

In California, there is a presumption that a settlor can revoke the trust. "Unless a trust is expressly made irrevocable by the trust instrument, the trust is revocable by the settlor." Probate Code §15400.

To summarize, the best practice is to draft the trust as revocable unless it is the beneficiary of retirement accounts or there are lifetime donors who may be more comfortable with an irrevocable trust. A revocable trust will allow for greater flexibility if the law changes or the beneficiary's circumstances change.

Section 4.02 Picking the Right Trustee is Key

The consensus among practitioners is that the selection of trustee is the single most important factor affecting the long-term success of a special needs trust. Choices include individual family members, corporate fiduciaries and professional trustees (i.e., individuals licensed by the State of California as "professional fiduciaries").

Typically, family members are not a good choice to serve as trustee. The reason is that there are so many traps for the unwary when administering a special needs trust, which can

cause loss of benefits, depletion of trust corpus, inappropriate distributions and/or investments.

Ideally, a "model" trustee would possess the following attributes:

- Understands public benefits laws
- Invest the money wisely
- Knowledgeable about the rules regarding trust distributions
- Recognizes fiduciary, tax compliance and accounting requirements for special needs trusts
- Can assemble a team of knowledgeable advisors to assist with the trust administration
- Advocates for the special needs beneficiary

(a) Trustee Resources

There are great resources for someone who is serving as trustee of a special needs trust. For example, The Special Needs Alliance publishes a manual "Administering a Special Needs Trust" and noted estate planning attorney Kevin Urbatsch has authored "Administering a California Special Needs Trust."

Section 4.03 Checks and Balances

Issue: How to keep the trustee accountable and avoid problems with having "sole and absolute" discretion? Two possibilities are to utilize a trust protector and/or trust advisory committee.

(a) Trust Protector

The role of the trust protector is becoming increasingly popular in estate planning. In the context of special needs trusts, a trust protector can provide oversight for the trustee and modify the trust, if needed, to adapt to change circumstances (e.g., law changes, changes in the beneficiary's circumstances such as moving to another state).

SAMPLE TRUST PROTECTOR PROVISION

"*Power to Amend Trust Agreement.* The Trust Protector may:

1. Add or modify terms of the trust so that the trust will protect the financial resources governed by this agreement and comply with the purpose of this trust that trust assets shall not be considered income or resources for all needs-based benefits from any agency, such as Regional Center services, Medicaid (in California Medi-Cal), Supplemental Security Income (SSI), In-Home Supportive Services (IHSS), Section 8 housing assistance, and any other special purpose benefits for which the Beneficiary is eligible or would be eligible if the terms of this trust were modified or supplemented;

2. Alter the administrative and investment powers of the Trustee to comply with any changes in the law;

3. Reflect tax or other legal changes that affect trust administration; and

4. Correct ambiguities, including scrivener errors that might otherwise require court construction or reformation."

(b) Trust Advisory Committee

Using a trust advisory committee is common in special needs trust planning. The committee can operate in an oversight function and help ensure the trustee is properly carrying out his or her duties in administering the trust.

SAMPLE TRUST ADVISORY COMMITTEE PROVISION

"*Trust Advisory Committee.* The purpose of the Trust Advisory Committee (TAC) is to provide insight, advice, and recommendations to the Trustee concerning administration issues and disbursements that are in the Beneficiary's best interest.

Role in Distributions. The TAC shall have the right to advise the Trustee on appropriate distributions. The Trustee should not make any distributions without first seeking the TAC's advice. The TAC serves in an advisory capacity only and has no authority to direct distributions. The Trustee also has no obligation to accept the TAC's advice with regard to trust distributions. If it is impossible or impractical for the Trustee to obtain the TAC's advice before a distribution, the Trustee may make a distribution without such advice."

The TAC may also arrange for periodic visits to the Beneficiary from a member of the trust advisory committee."

Section 4.04 Funding the Special Needs Trust

Parents or guardians want to ensure that a child with special needs will remain financially secure even when they are no longer there to provide support. Like a client's revocable living trust (which requires funding to achieve the desired benefits, e.g., incapacity planning and probate avoidance), designing and executing the special needs trust is only the first step. Thus, the trustee (with assistance from the advisory team) must determine how much to put into the trust and how the trust will be funded.

(a) Calculating the Funding Amount

It's important to engage professionals such as "life care planners" and/or others with expertise in planning for persons with disabilities. Calculations to determine "how much" should address the following:

- Availability of other private support (e.g., parents, including life insurance, grandparents, etc.)
- Cost of ongoing care and treatment plans
- Availability of public benefits
- Integration of estate plan with public benefits (e.g., by using third party special needs trust funded with parents' assets)

There are "big picture" questions associated with estimating future costs, such as housing (where, with whom, who will pay); care (what type, how

much, how often, what skill level, who will pay); quality of life (how will people stay involved with the child, what does he/she enjoy); risks (serious medical problems, loss of public benefits).

Then, these are common expenses to estimate with the client: housing, care assistance, therapies, personal (food, clothing, entertainment), transportation, social (visits with extended family, sports, camps), medical/dental. It's a good idea to elicit a best-case and worst-case scenario from the parent, so you can calculate the need based on each scenario and generate a range to estimate a minimum and maximum funding amount.

(1) Life Care Plan

This tool is generally used by litigators to evaluate the future cost of care for plaintiffs, and can be a valuable resource to determine future costs of care for a SNT beneficiary. For example, the life care plan for a 15-year old client who suffered a traumatic brain injury (TBI) showed total medical/psychological costs of care for her lifetime (another 66.5 years), would be about $13,000,000. The point is that each case will be different but the Life Care Plan is a tool to assess potential future needs of a special needs trust beneficiary.

(b) Funding the Trust

Available options include funding the trust via the client's estate plan, using retirement assets and life insurance.

(c) Life Insurance

Whatever type of insurance policy is chosen, the policy must name the trustee of the special needs trust, in his or her capacity as trustee, as beneficiary of the policy, rather than naming either the trust itself or the individual with special needs.

(d) Retirement Plan Assets

A client's retirement plan can be a good option to fund a special needs trust.

By way of background, clients with significant retirement plan (e.g., IRA) assets may be reluctant to name an individual as "designated beneficiary" to receive the account proceeds upon the participant's death. Perhaps the beneficiary is a person with a disability, a minor and/or lacks the ability to handle large sums of money. Maybe there are concerns about asset protection.

For these reasons, clients may decide to name a trust as IRA beneficiary so that the trust provisions will control the distributions. In this case, the trust must qualify as a "Designated Beneficiary" for purposes of determining the required minimum distributions (RMDs) each year.

(e) Trust Requirements to be a "Designated Beneficiary"

Although a "designated beneficiary" is usually an individual, you can name a trust as beneficiary and it will qualify as a "Designated Beneficiary" for purposes of the MRD rules, provided it satisfies certain requirements:

- The trust must be valid under state law
- The trust is irrevocable, or will, by its terms, become irrevocable upon the participant's death
- The trust beneficiaries are identifiable from the trust document
- Certain documentation must be provided to the plan participant
- All trust beneficiaries must be individuals

Reg. §1.401(a)(9)-4, A-5(b)

(f) Two Types of "Designated Beneficiary" Trusts

The IRS recognizes two types of trusts to determine Designated Beneficiary status, i.e., "conduit trusts" and "accumulation trusts."

In a conduit trust, the trustee is required to distribute all qualified retirement plan distributions outright to the trust's beneficiary. By definition, any trust that is not a conduit trust is an accumulation trust. In an accumulation trust, the trustee has the ability to hold property for the benefit of the beneficiary, and is not required to make distributions.

A conduit trust should not be used in planning for a needs-based public benefits recipient because of its requirement to make minimum distributions. On the other hand, an accumulation trust can be an effective method of handling the retirement plan assets. Keep in mind that the remainder beneficiaries should be individuals who are close in age to (or younger than) the person with a disability, e.g., siblings. The reason for choosing "natural persons" as contingent beneficiaries is that if a contingent beneficiary is a charity or the estate, then the trust won't be considered a designated beneficiary.

(g) Participant Already Deceased

If the participant has already died and left the benefits outright to a person with a disability, and preserving government benefits is desired, the beneficiary's guardian could seek a court order to establish a first party "(d)(4)(A)" special needs trust.

In one case, a father named his four sons as equal beneficiaries of his IRA. One son was a person with a disability who received needs-based public benefits. The surviving spouse obtained a court order to establish a first party special needs trust for the son's sole benefit, thus preserving his public benefits. (See IRS Private Letter Ruling 200620025, which also concluded that the required minimum distributions from the IRA to the child's first

party special needs trust could be calculated based on the child with a disability's life expectancy.)

Chapter Five
Trust Administration and Taxation

Section 5.01 Trust Administration in General

In many ways, administering a special needs trust is similar to managing any other trust for a beneficiary. In a nutshell, a trustee's job is to carry out the settlor's instructions, administer the trust according to its terms, and protect the beneficiaries. Thus, the trust instrument gives a trustee power to make distributions (of trust income and/or principal) according to the trust's guidelines and perform other acts such as investing the trust assets, paying expenses, filing tax returns and maintaining books and records.

The trustee's authority to act is found in the trust instrument, state statute (i.e., the California Probate Code) and case law. In addition, the trustee of a special needs trust must consider the law, rules and regulations regarding public benefits. These rules are generally found in the Social Security Act law and regulations and the Program Operation Manual System (POMS).

Acting as a trustee is a serious undertaking, especially for a special needs trust which demands specialized knowledge in the area of public benefits law. In particular, the trustee must understand how trust distributions can affect public benefits. The SNT trustee may also become involved with hiring a caregiver, case manager, or advocate for the beneficiary.

If a trustee violates any duty owed to a beneficiary, the trustee may be liable for a breach of trust. Probate Code §16400.

Section 5.02 Trust Distributions

The distributions provisions are among the most important provisions of the special needs trust. By the trust terms, the trustee has total discretion regarding whether, and to what extent, to make distributions.

(a) Income and Resource Rules

The trustee must understand the applicable limitations regarding income, resources and in-kind support and maintenance (see Chapter Two). In addition, the trustee needs to keep an accurate account of how trust assets are invested and spent. This will be important if a government agency requests verification of trust disbursements and/or expenditures.

SAMPLE PROVISION FOR DISCRETIONARY DISTRIBUTIONS

"*Distributions Shall Be Supplemental*. It is the purpose of this trust that the trust estate shall be used to supplement public benefits, not supplant them. For purposes of determining Beneficiary's eligibility for SSI, Medi-Cal, In-Home Supportive Services, HUD housing benefits, Regional Center services, and any other program of public benefits, no part of the undistributed income or principal of the trust estate shall be considered available to Beneficiary.

By way of illustration, and not limitation, the term “special needs” includes basic living needs such as dental care, medical care, custodial care, support services, and similar care not provided by public benefits programs, which are related to and made reasonably necessary by the Beneficiary’s disabilities. The Trustee is directed to consider these basic living needs when making distributions.

“Special needs” may include, but is not limited to, the following goods and services: clothing; telephone (cell phone or land line); Internet and television (cable or satellite); hair and nail care; furniture, as well as bedding and laundry; audio, video, and computer equipment; adaptive equipment; companion service animals; toys, musical instruments, and electronic devices; services to maintain the Beneficiary’s equipment and household; vehicles and services to improve and maintain such vehicles; newer and more effective medications than Medi-Cal allows; more sophisticated medical or dental or diagnostic work or treatment for which funds are not otherwise available; other nonessential medical procedures (such as massage therapy or acupuncture); periodic outings and vacations (and other items to enhance the Beneficiary’s quality of life, self-esteem, or situation); pre-need funeral and burial expenses; and taxes. “Special needs” may include contracting for private health insurance and payment of premiums on such insurance when the trustee determines that such health insurance coverage is in the best interest of the Beneficiary.

“Special needs” will not ordinarily include basic support, such as food, shelter, and medical care already paid for by Medi-Cal. However, “special needs” may include such basic needs if the Trustee determines that they are inadequately met by the level or kind of public benefits actually provided. “Special needs” may also include basic needs if support for such needs is not available at all, *e.g.,* as a result of public benefit program terminations, changes in program standards under which the Beneficiary no longer qualifies, or the Beneficiary’s loss of benefits on account of his earnings, unearned income, or assets.”

(1) Categories of SNT Distributions

Under the SSA rules, distributions are treated as direct income, not income, in-kind income or in-kind support and maintenance. The timing is important because SSA considers a distribution as income in the month of receipt. In the following month, the distribution itself (or the asset purchased) would be considered a resource.

For example, if the trustee gives money directly to the beneficiary, this is “direct income” resulting in a dollar-for-dollar reduction in SSI benefits (after $20 exclusion). Distributions that are “not income” include payments to a third party for certain services (e.g., physical therapy and social services) and distributions of exempt items to the beneficiary (e.g., household goods or a television).

(b) Create a System for Disbursements

The trustee should implement a clear procedure for requesting, evaluating and making distributions. This process may involve creating a monthly

budget to pay recurring expenses and participation by legal guardians, friends and family members, as appropriate.

(c) Methods of Making Distributions

The trustee should never distribute cash directly to the beneficiary nor reimburse the beneficiary for purchase he or she makes. On the other hand, the trustee can pay a vendor or service provider directly for goods and services (e.g., cable bill and cell phone). Another method is for the trustee to provide the beneficiary with a gift card (provided it is not transferable nor convertible to cash).

If the beneficiary qualifies for a credit card, the trustee can pay the bill. This works because the trustee is directly paying a valid debt of the beneficiary. The trustee must also exercise discretion over each item listed on the bill.

There is another option available to trustees who deal with the issue of how to "control" expenditures. Practitioners have recommended using the "True Link Card" for an increasing number of beneficiaries as a means to control expenditures for a beneficiary. This is a reloadable Visa card that offers special needs trustees, guardians, representative payees and other professionals a simple way to disburse funds to beneficiaries, manage where money can be spent and protect beneficiaries' finances.

Section 5.03 Trust Investments

The first question is whether the trust is a third party SNT or a court established first party SNT. If the first party SNT is court supervised, then the trustee's choice of investments is limited. See California Rule of Court 7.903.

SAMPLE INVESTMENT POWERS PROVISION

"A. Except as authorized by court order, the Investment Trustee shall have the power to invest trust funds, without court authorization, as set forth in Probate Code §2574. The Investment Trustee, without court authorization, may invest funds in:

1. Direct obligations of the United States, or of the State of California, maturing not later than 5 years from the date of making the investment.

2. United States Treasury bonds redeemable at par value on the death of the holder for payment of federal estate taxes, regardless of maturity date.

3. Securities listed on an established stock or bond exchange in the United States that are purchased on such exchange.

4. Eligible securities for the investment of surplus state moneys as provided for in Government Code §16430.

5. An interest in a money market mutual fund registered under the Investment Company Act of 1940 (15 United States Code §§80a-1 through 80a-64) or an investment vehicle authorized for the collective investment of trust funds pursuant to §9.18 of Part 9 of Title 12 of the Code of Federal Regulations, the portfolios of which are limited to United States

government obligations maturing not later than 5 years from the date of investment and to repurchase agreements fully collateralized by United States government obligations.

6. Units of a common trust fund described in Financial Code §1564. The common trust fund shall have as its objective investment primarily in short-term fixed income obligations and shall be permitted to value investments at cost pursuant to regulations of the appropriate regulatory authority.

B. The Investment Trustee has also obtained court authorization to invest trust assets in:

1. Mutual funds, held and traded in the United States.

2. Direct obligations of the United States, or of the State of California, maturing later than 5 years from the date of making the investment."

Section 5.04 Home Ownership Issues

If the special needs trust has adequate funding, a home purchase may be appropriate. According to the POMS, if the trustee of a trust which is not a resource for SSI purposes purchases and holds title to a house as a home for the beneficiary, the house would not be a resource to the beneficiary. It would also not be a resource if the beneficiary moved from the house. The trust holds legal title to the house and, therefore, the eligible individual would be considered to be living in his or her own home based on having an "equitable ownership under a trust."

Then, the trustee should be aware of and consider the following issues:

If purchased outright, the home purchase would be considered income (ISM) in the month of purchase only. This ISM is valued at no more than the presumed maximum value, or $277. After the first month, the beneficiary can live rent-free in the home without the arrangement being treated as ISM. On the other hand, if the home is acquired with a mortgage, payment of the mortgage is a disbursement to a third party, resulting in ISM.

Another possibility would be acquiring the home in a form of joint ownership (e.g., as tenants-in-common) with another family member if necessary.

(a) Can the Beneficiary Own Home?

The short answer is "yes." Provided the trustee has authority, the special needs trust trustee can buy a home and distribute it to the beneficiary. A public benefits recipient can own a home of any value without affecting SSI.

(b) Other Household Expenses

Certain household operating expenses are considered shelter and, therefore, result in ISM to the beneficiary. These expenses include, without limitation, the following items: mortgage, rent, property taxes, gas, electricity, water and homeowner's insurance required by a lender. On the other hand, disbursements from the trust for *improvements* increase the value of the residence and do not result in ISM.

(c) Property Tax Issues (Proposition 13)

Under the general rule, transferring real property to a trust is a change in ownership unless an exception applies. Two common scenarios (and exceptions) are when parents transfer their principal residence to a third party special needs trust and when an individual transfers his or her own home to a first party special needs trust.

(d) Income Tax Issues

If the property is included in the gross estate of the deceased beneficiary (e.g., in the case of a first party special needs trust), a basis step-up is available. Similarly, the Code Section 121 capital gains exclusion may be available if the trust qualifies as a grantor trust and the beneficiary satisfies the applicable rules.

(e) Sale of Home

The sale of a home owned by a special needs trust won't affect the beneficiary's eligibility for public benefits. However, according to the POMS, when an *individual* sells an excluded home, the proceeds of the sale are excluded resources if the individual plans to use them to buy another excluded home, and does so within three (3) full calendar months of receiving them.

EXAMPLE: The settlor of a special needs trust wants the SNT to purchase a condominium for his son (who receives SSI benefits) to reside in and rent the condo to two other individuals for $800 a month. The SNT will also pay monthly HOA fees of $480 and property taxes of $520 per month from the rental income.

Issues: If the SNT pays the HOA fees and property taxes, are these operating expenses treated as "shelter" for ISM purposes, thereby reducing the son's benefit? What if the renters pay the HOA fees and property taxes directly? Do rent payments affect the son's benefits?

Section 5.05 Taxation

Among the trustee's duties are filing the necessary tax returns and paying the taxes. The following discussion covers the main income tax issues regarding special needs trusts, although the trustee may need to consider potential estate, gift and employment tax issues.

(a) Basic Filing Requirements

The trustee must file a federal return (Form 1041) if the trust has any taxable income, gross income of $600 or more (regardless of taxable income) or a beneficiary who is a nonresident alien. The trustee must file a California return (Form 541) if the trust has gross income exceeding $10,000 (regardless of net income) or net income greater than $100.

(1) What is Income?

The definition of income is different for income tax purposes compared with the definition of income for SSI eligibility. Thus, some items that are reported on the individual's income tax return are not treated as income for SSI eligibility purposes (e.g., undistributed income in a (d)(4)(A) SNT). The opposite is also true, i.e., some items that are counted as income for SSI qualification purposes are not treated as income for tax purposes (e.g., trustee's payment of the beneficiary's rent from the principal of an SNT).

(b) Classifying the Trust as a Grantor or Nongrantor Trust

As a threshold matter, it's important to recognize and understand the difference between a "grantor" trust and a "nongrantor" trust. If a settlor has substantial control over the trust and is treated as the "owner" for tax purposes, then the trust would be categorized as a "grantor" trust under the grantor trust rules (IRC 671—679). When a trust is a grantor trust for income tax purposes, the grantor reports all items of income, deduction and credit on the grantor's individual income tax return. Code Section 671. Alternatively, if the trust is a nongrantor trust, it is a separate entity for income tax purposes. Therefore, the trust itself pays the tax associated with any net trust income not distributed to the beneficiary. A nongrantor trust files annual federal and California fiduciary income tax returns to report the trust's income, deductions and credits. When a nongrantor trust is established or a successor trustee takes office, Form 56 (Notice Concerning Fiduciary Relationship) should be filed with the IRS and Franchise Tax Board.

(1) Simple and Complex Trusts

A "simple trust" is one that is required to distribute all of its income currently whether or not distributions of current income are in fact made. The trust instrument for a simple trust does not provide for charitable contributions (IRC 651). A trust may be a simple trust even though under local law or under the trust instrument capital gains must be allocated to corpus. The "income" required to be distributed in order to qualify for classification as a simple trust is the income under local law and the governing instrument. The term "complex trust" applies to all trusts other than those described above.

(c) First Party Special Needs Trusts

A first party special needs trusts is generally treated as a "grantor trust." Thus, all of the items of income, deduction and credit generated by the trust should be reflected on the personal income tax return of the individual with the disability, i.e., the trust beneficiary. In first party special needs trusts,

the grantor is actually the beneficiary because the law requires the trust be funded with the beneficiary's own assets.

Having the beneficiary as taxpayer will maximize use of his/her tax brackets and ability to deduct potentially large medical expenses.

(d) Third Party Special Needs Trusts

Third-party special needs trusts are generally either considered complex trusts or qualified disability trusts for income tax purposes, and the trust itself is responsible for reporting its own items of income, deduction and credit. Thus, a third party special needs trust is generally taxed as a nongrantor trust.

Typically, third party special needs trusts are created under the settlor's will or trust, or during lifetime via a standalone document.

A testamentary third party SNT is always taxed as a nongrantor trust. If the trust is created during the settlor's lifetime, it can be designed as a grantor trust or nongrantor trust.

If the trust is a grantor trust, the settlor (typically a parent or grandparent) can pay the tax liability associated with the trust income and gains, allowing the trust assets to grow without being diminished by taxes. Further, the IRS has ruled that payment of the income taxes is not treated as an additional gift by the donor. See Rev. Rul. 2004-64, clarifying the tax treatment of a grantor who pays the income tax attributable to the trust assets.

Also, if the settlor is paying medical expenses and the beneficiary is the settlor's dependent, the grantor trust classification would enable the settlor to claim the medical expense deduction.

PRACTICE POINTER: Since a trust hits the highest marginal tax rate (37 percent) at a much lower net income level than individuals ($12,750 in 2019 compared with $510,300 for an individual taxpayer), it's generally better for the trust beneficiary or grantor to bear the tax responsibility.

In addition, a third party special needs trust trustee should determine whether to make year-end distributions to "carry out" income to the beneficiary and/or make the "65-day election" and have disbursements made within 65 days of the end of a tax year treated as being made in the prior year.

SAMPLE GRANTOR TRUST LANGUAGE

"By reserving the broad rights and powers set forth in Section XX of this Article (including the power to revoke the trust and control distributions of income and principal), I intend for the John Adams Special Needs Trust to be classified as a "Grantor Trust" under Sections 671 to 679 of the Internal Revenue Code until the trust becomes irrevocable, as set forth in Section XX. Until the trust becomes irrevocable, I will be treated as the owner, for income tax purposes, of all the assets held in the John Adams Special Needs Trust as though I held them in my individual capacity.

> During any period that my trust is a Grantor Trust, the taxpayer identification number of my trust shall be my Social Security number, in accordance with Treasury Regulation Section 301.6109-1(a)(2)."

Thus, if a third party special needs trust is funded while grantor retains power to revoke the trust, it will be taxed as a grantor trust and includible in grantor's estate for estate tax purposes.

Section 5.06 Payment of Medical Expenses

When the trustee of a third party SNT pays the beneficiary's medical expense, this is treated as a distribution to the beneficiary. To the extent the payment is made from distributable net income (DNI), the trust would claim an income distribution deduction. With a first party SNT (i.e., a grantor trust), the beneficiary can claim an income tax deduction for medical expenses paid by the trust.

Section 5.07 Qualified Disability Trust

This is a tax classification that is unique to trusts where there is a beneficiary who has been determined disabled by the Social Security Administration. A trust can increase its personal exemption if it is a "qualified disability trust." This classification generally applies only to third party special needs trusts.

The annual amount a qualified disability trust is allowed to deduct for tax years beginning after December 31, 2017, and before January 1, 2026, is modified (Code Sec. 642(b)(2)(C)(iii)). For those tax years, when the personal exemption is repealed and effectively zero, the annual deduction is $4,150, indexed for inflation after 2018.

To be a "qualified disability trust" the trust must qualify as a disability trust under section 1917(c)(2)(B)(iv) of the Social Security Act (42 U.S.C. 1396p). Also, all of the beneficiaries at the end of the taxable year must have been determined disabled by the Commissioner of Social Security under section 1614(a)(3) of the Social Security Act (42 U.S.C. 1382c(A)(3)) for some portion of the year. The fact that a disability trust may revert to a disabled person, upon termination, will not disqualify it from being a "qualified disability trust."

To summarize, the trust must be:

- A nongrantor trust;
- Irrevocable; and
- Established for the sole benefit of a person under age 65 who is also disabled as defined by SSA (i.e., receiving either SSI or SSDI)

Section 5.08 Trust Termination

There are circumstances when it may be advisable to terminate a special needs trust, e.g., depletion of trust assets, if the beneficiary no longer has a disability, becomes gainfully employed or passes away. Then, the trustee must follow the appropriate procedures depending on whether the trust is a first party or third party special needs trust.

Chapter Six
The Achieving a Better Life Experience (ABLE) Act

Section 6.01 Background

The Stephen Beck, Jr., Achieving a Better Living Experience (ABLE) Act of 2014, enacted on December 19, 2014, as part of the Tax Increase Prevention Act of 2014 (Public Law 113-295), added Section 529A to the Internal Revenue Code. Congress recognized the special funding burdens borne by families raising children with disabilities and the fact that increased financial needs generally continue throughout the person with a disability's lifetime.

In a nutshell, ABLE accounts represent a new type of tax-favored savings account modeled after qualified tuition programs (known as "529 Plans"), which can be used to pay a beneficiary's "qualified disability expenses."

As of this writing, most states have implemented ABLE accounts and many offer nationwide enrollment.

RECENT DEVELOPMENT

Under the Tax Cuts and Jobs Act, individuals are allowed to roll over amounts from qualified tuition plans (529 Plans) to an ABLE account if the ABLE account is owned by the same designated beneficiary of the 529 Plan or a member of the designated beneficiary's family before January 1, 2026. Under certain circumstances, the contribution limitation to ABLE accounts is increased for contributions made by the designated beneficiary before January 1, 2026.

Section 6.02 ABLE Account Highlights

The ABLE Act creates tax-favored savings accounts for individuals with disabilities for tax years beginning after December 31, 2014. The ABLE Act authorizes states to create an ABLE Program (similar to Code Section 529 college savings programs).

Individuals with disabilities are limited to one ABLE account and total annual contributions by all individuals to any one ABLE account could be made up to the gift tax exclusion amount. For 2019, the gift tax exclusion amount is $15,000.

The ABLE Act also authorizes investment direction for these plans by an account contributor or designated beneficiary up to two times each year. The change is effective for tax years beginning after December 31, 2014.

A key benefit of Section 529 ABLE accounts is that, unlike other assets of a person with a disability, the value of a 529A plan is generally *not* considered when determining eligibility for means tested Federal and state aid such as SSI and Medi-Cal. The main exception to this rule is that any amount in an ABLE account, including earnings, in excess of $100,000 shall be considered a resource of the designated beneficiary.

See POMS SI 01130.740 for the SSA's rules on the administration of ABLE accounts.

Section 6.03 Doing Your Homework

Before deciding if an ABLE account is suitable, the client should identify short and longer-term needs requiring financial assistance, consider whether such expenses will be covered by any public benefits programs, and think about other sources of income (e.g., employment, SSI, SSDI or an SNT) which an ABLE account may complement.

Section 6.04 ABLE Account Benefits

There are benefits to establishing an ABLE account, even when funded from family members whose contributions may ultimately become subject to the Medi-Cal payback provision.

First, there is the favorable income tax treatment itself. These new plans enjoy tax-free growth (when used for qualified expenses, described below), while third party special needs trusts are typically subject to income taxation (and at compressed trust tax rates with a top 37 percent rate beginning at $12,750 of income in 2019), improved only slightly by the higher personal exemption available for a qualified disability trust.

Second, there are professional fees and other costs to design and draft a special needs trust, file annual tax returns for the trust, and administer the trust. These costs should be largely eliminated by using a Section 529A plan (which will likely have a modest annual maintenance fee). Also, if the anticipated trust contributions won't exceed the applicable limitations, and/or where the funds are expected to be used during the life of the beneficiary, the issues of potential SSI disqualification and Medicaid payback may be moot.

Section 6.05 Who Qualifies for an ABLE Account?

An individual eligible must be disabled or blind, and the onset of the disability or blindness must have occurred before the individual attains age 26. The person must be entitled to benefits based on blindness or disability under title II of the Social Security Act (i.e., receiving SSI or SSDI). Alternatively, there is a certification process requiring the person to have a disability certificate on file with the IRS for the tax year.

(a) Disability Certificate

A disability certificate can be submitted by either the individual, or the parent or guardian of the individual. It must certify that the individual has a medically determinable physical or mental impairment resulting in marked and severe functional limitations that can be expected to result in death, or have lasted or be expected to last for a continuous period of not less than 12 months, or is blind with the meaning of section 1614(a)(2) of the Social Security Act. When filing the disability certificate, a copy of the individual's diagnosis related to the individual's relevant impairment or impairments is signed by a physician meeting the requirements under section 1861(r)(1) of the Social Security Act.

Section 6.06 Contributions

Contributions up to the annual gift tax exclusion amount (currently $15,000 and indexed for inflation) can be made to an ABLE account on an annual basis, and distributions are tax-free if used to pay qualified disability expenses.

Under the Tax Cuts and Jobs Act, the contribution limit to an ABLE account is temporarily increased in certain circumstances. While the general contribution limit remains the same (i.e., equal to annual gift-tax exclusion), it is increased with regard to contributions made by the designated beneficiary before January 1, 2026). Specifically, after the general limitation on contributions is reached, the designated beneficiary of the ABLE account may make additional contributions up to the lesser of: (1) his or her compensation includible in gross income for the tax year; or (2) the federal poverty line for a one-person household.

Contributions aren't deductible for federal income tax purposes. However, some state programs authorize a state tax deduction for residents of that particular state.

The account can be established by the person with a disability, or created as a custodial or trust account by others for the benefit of the person with a disability.

Aggregate contributions to an ABLE account would be subject to an overall limit matching the state limit for Section 529 educational accounts ($529,000 in California).

Qualified individuals or their families can open an ABLE account in any state that offers a nationwide ABLE program.

Section 6.07 Distributions

Distributions from an ABLE account are excluded from the designated beneficiary's gross income to the extent of his or her "qualified disability expenses" for the tax year. Qualified distributions include amounts used to cover medical expenses as well as costs of education, transportation and housing. Distributions used for nonqualified expenses would be subject to income tax on the portion of the distributions attributable to earnings from the account, plus a ten percent penalty.

Section 6.08 Rollovers and Change of Beneficiaries

A rollover distribution from one ABLE account to another, whether in the same ABLE program or a different ABLE program, that meets certain conditions is not includible in the distributee's gross income. To be excluded from income, the distribution must be paid into another ABLE account in a qualified ABLE program no later than sixty (60) days after the date of payment or distribution.

A change of designated beneficiary of an ABLE account is not treated as a distribution for purposes of IRC 529A (and is not includible in gross income) if the successor designated beneficiary is an eligible individual for such calendar year and a member of the former designated beneficiary's family.

Finally, amounts from 529 Plans can be rolled over to an ABLE account without penalty, if the ABLE account is owned by the designated beneficiary of that 529 account or a member of the designated beneficiary's family before January 1, 2026. However, any rolled-over amounts count towards the overall limitation on amounts that can be

contributed to an ABLE account within a tax year. Plus, an amount rolled over that exceeds the limitation will be included in the beneficiary's gross income under the annuity rules of Code Section 72, unless excludable under another Code section.

Section 6.09 Qualified Disability Expenses

"Qualified disability expenses" means any expenses related to the eligible individual's blindness or disability that are made for the benefit of an eligible individual who is the designated beneficiary, including expenses related to education, housing, transportation, employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, funeral and burial expenses, and other expenses, which are approved by the Secretary of the Treasury under regulations and consistent with the purposes of the federal ABLE Act.

The IRS is authorized to approve other expenses for these purposes.

Section 6.10 ABLE Accounts in California

In 2015, Governor Brown signed the California ABLE Act into law, establishing the California ABLE Act Board, which administers the CalABLE Program. The CalABLE Savings Plan opened to the public on December 18, 2018.

This link provides additional information on the Cal ABLE Program:

https://www.treasurer.ca.gov/able/resources/factsheets/factsheet-en-us.pdf

This link is useful to compare ABLE plans nationwide:

https://ablenrc.org/state-review

Section 6.11 Payback Provision

ABLE accounts are subject to reimbursement to the state for Medi-Cal costs provided to the beneficiary.

Upon the death of a designated beneficiary, all amounts remaining in the qualified ABLE account, subject to any outstanding payments due for qualified disability expenses, not in excess of the amount equal to the total medical assistance paid for the beneficiary after the establishment of the account, shall be distributed to the state upon the filing of a claim for payment.

However, assets in an ABLE account may be rolled over without penalty into another ABLE account for the designated beneficiary (e.g., when moving to another state) or any of the beneficiary's qualifying family members, such as siblings.

Section 6.12 Continued Use of SNTs

For many clients, ABLE accounts will not eliminate the need for special needs trusts. Although ABLE accounts are easier and cheaper to establish than SNTs, they are subject to many restrictions, including the annual and total contribution limitations described above. In addition, ABLE accounts are subject to reimbursement to the State of California for Medi-Cal benefits received. If the ABLE account balance exceeds $100,000 and the

amount in excess causes an SSI beneficiary to exceed the SSI resource limit, then the beneficiary's SSI benefits would be suspended without time limit, but not terminated. In this situation, the person's Medi-Cal/Medicaid benefits would remain intact.

On the other hand, third party SNTs offer design flexibility, have no limit on contributions, impose no age restrictions and money doesn't have to be spent on "qualified disability expenses."

Thus, ABLE accounts may compliment the use of special needs trusts, especially for parents who want to make annual gift contributions or in the case of a modest personal injury settlement.

Section 6.13 Proposed IRS Regulations and Guidance

On June 19, 2015, the IRS and the Department of the Treasury released proposed regulations providing rules by which states or state agencies or instrumentalities may establish a qualified ABLE program through which contributions may be made to the account of an eligible disabled individual to meet qualified disability expenses. These accounts are generally disregarded for purposes of certain means-tested Federal programs.

The proposed regulations provide guidance to state programs, designated beneficiaries and other interested parties on a number of issues. The IRS has developed two forms that ABLE account programs will use to report relevant account information annually to designated beneficiaries and the IRS: *Form 1099-QA* for distributions and *Form 5498-QA* for contributions.

The IRS has issued guidance announcing that they intend to issue regulations clarifying that a distribution from a qualified tuition plan (QTP) made after December 22, 2017, and before January 1, 2026, to the ABLE account of the designated beneficiary of that QTP, or of a member of the family of that designated beneficiary, is not subject to income tax if two requirements are satisfied. First, the distributed funds must be contributed to the ABLE account within 60 days after their withdrawal from the QTP. Second, the distribution, when added to all other contributions made to the ABLE account for the taxable year that are subject to the annual gift tax limitation, are subject to the limitation. Notice 2018-58, I.R.B. 2018-33, 305.

The IRS has issued guidance announcing that they intend to issue proposed regulations clarifying recent law changes to the limits on contributions to ABLE accounts. The guidance includes rules on: (1) additional contributions by an employed designated beneficiary; (2) the definition of poverty line; and (3) excess contributions from the designated beneficiary. Notice 2018-62, I.R.B. 2018-34, 316.