



Exercising Distribution Discretion Under a Special Needs Trust

HARRIET P. PRENSKY AND PATRICIA TOBIN

A gift or devise to a handicapped or disabled person may cause the recipient to lose eligibility for public benefits such as Supplemental Security Income (SSI) or Medi-Cal. In order to avoid this result, the transferor may establish a special needs trust for the benefit of the handicapped or disabled person. Such a trust gives the trustee broad discretion in determining the manner and extent to which the trust estate will be used to assist the beneficiary, and specifically authorizes the trustee to refuse to make distributions that would jeopardize eligibility for public benefits. (For a detailed discussion of the purposes of these trusts, drafting considerations, and forms, see 2 California Will Drafting, chap 23 (Cal CEB 1992).) The intent of these trusts is to supplement the beneficiary's basic needs (which are covered by public benefits), and to use the trust funds to pay for the beneficiary's "special needs" (those needs not covered by public benefits).

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The use of special needs trusts will probably expand with the enactment of Stats 1992, ch 355 (AB 3328—Horcher). The chapter amends existing Prob C §§3600-3612 provisions regarding the disposition of money payable to a minor or incompetent person as a result of a judgment or settlement. The new law permits the court to order the funds transferred to a special needs trust meeting specified requirements if there is a showing that the minor or incompetent has a substantial handicap.

Administering these trusts in a way that maximizes benefits for the beneficiary can be a challenging task. The trustee must understand the available programs and applicable eligibility rules. Failure to do so can result in needless loss of benefits, or needless failure to take advantage of opportunities for improving the quality of life of the beneficiary. This article provides an overview of the more common benefit programs available to typical special needs trust beneficiaries and illustrates strategies that may be available to make the best use of the trust estate. It assumes that the practitioner is advising the trustee of a special needs trust that has already been drafted. The issues involved in trust drafting will not be discussed.

Determining Available Public Benefits and Applicable Eligibility Rules

Eligibility rules vary widely depending on the public benefit provided. In general, there are certain public benefit programs that are based on financial need and others that are not. For example, the Medicare program, which provides health coverage, has no income or resource restrictions. Therefore, a distribution from a special needs trust will have no effect on a recipient's benefits. However, Medi-Cal benefits may be terminated if the recipient receives a cash distribution from a trust. The following is a cursory overview of the primary benefits available to special needs trust beneficiaries and the applicable eligibility rules.

Social Security: Medicare and Retirement Benefits

The Social Security Administration (SSA) administers a number of benefit programs. Two of these programs provide the most well-known benefits: (1) Medicare (a health insurance program), and (2) Social Security retirement benefits.

Generally, eligibility for Medicare is tied to eligibility for Social Security or railroad retirement income. A beneficiary of such benefits is entitled to Medicare if the beneficiary is age 65 or older, regardless of whether the beneficiary is retired. Beneficiaries under age 65 who are receiving Social Security disability benefits qualify re-

Regardless of age if they have been eligible for payment status for more than 24 months. Medicare is also available for persons suffering from end stage renal disease (kidney failure). Persons over 65 who are not linked to Social Security or the railroad retirement system can purchase Medicare.

In all cases, Medicare eligibility is dependent on status as an insured worker or through derivative dependent status. Eligibility is not dependent on the extent of the recipient's income or assets. Initial eligibility is obtained by applying at the Social Security office. Benefits are obtained by filing claims, and there are no ongoing reporting requirements. Social Security retirement benefits provide monthly cash payments to covered workers. Often teachers and other government employees will not be covered by Social Security.

Social Security: Benefits for Disabled Persons

Two related programs are (1) Social Security Disability Insurance (SSDI), and (2) disabled dependent benefits. SSDI covers disabled workers under age 65 who are unable to perform substantial gainful activity (SGA). Beneficiaries must have a physical or mental impairment which is expected to last more than 12 months or is terminal. In addition, beneficiaries must have attained a minimum level of coverage from past Social Security covered employment.

Benefits for a disabled dependent cover the wage earner's disabled adult children and disabled spouses. When a covered wage earner dies, becomes disabled before age 65, or retires, his or her disabled adult child will become eligible for an additional monthly payment equivalent to 50 percent to 75 percent of the parents' Social Security benefit, if the child was disabled before age 22. After receiving payment for 24 months, the child or spouse also becomes eligible for Medicare. This dependent coverage and SSI (see below) are the benefits of most concern to estate planners who advise disabled clients or clients with disabled family members.

Retirement benefits, SSDI, and dependent benefits are classified as the Old Age Survivors and Disability Insurance (OASDI) program and these benefits do not depend on financial need. (For convenience the non-needs-based program is often abbreviated "SSA" and the needs-based program is termed "SSI." See below.)

Generally, the SSA eligibility rules do not pose significant problems for the trustee of a special needs trust. With a significant exception, eligibility is not dependent on the current income or assets of the beneficiary. Benefits may be affected if the beneficiary has income from employ-

ment or self-employment and the beneficiary is under age 70, but benefits are not affected by receipt of trust distributions. Similarly, eligibility is not related to the amount of property owned by the beneficiary. Accordingly, no loss of benefits results when the beneficiary accumulates and retains trust distributions. Nor is it necessary to be concerned with whether the assets of the trust might be treated as belonging to the beneficiary. Consistent with these rules, persons under age 70 must report wages and self-employment earnings, but other income will not affect eligibility. Of course, beneficiaries may have reporting responsibilities for tax purposes.

Social Security: Supplemental Security Income

The last of these Social Security programs is called Supplemental Security Income (SSI). SSI is a cash grant program available only to low-income, low-asset applicants. This program is critical because, in California, eligibility for SSI automatically qualifies the recipient for Medi-Cal. Medi-Cal is the comprehensive health insurance program of last resort.

Maximum SSI benefits. The current maximum federal benefit is \$422 per month. Current total benefits, following recent California budget cutbacks, are:

1992 MONTHLY SSI RATES IN CALIFORNIA FOR AGED OR DISABLED RECIPIENTS:

	<u>Nov./Dec. 1992</u>
Child living with family:	\$465.40
Adult receiving support in the household of another:	482.00
Adult living independently:	608.00
Adult living independently without access to cooking facilities:	676.00
Adult couple, over 65:	1121.00

SSI recipients who also receive Social Security benefits may add \$20 to these figures. Blind recipients are entitled to slightly higher amounts.

SSI Eligibility

SSI eligibility is based on status, assets (also called property or resources), and income. Income and asset rules are specific to the SSI program and are not consistent with income or estate tax concepts. The asset and income rules are complex, but must be clearly understood by the trustee of the special needs trust.

Status Requirements

Benefits are available for persons who are aged (over age 65), disabled, or blind. Applicants must be United States citizens, lawful permanent residents (green card), or they must reside in the United States "under color of law" (a legal exception under immigration law).

Income Requirements

Recipients must have a monthly *countable* income less than approximately \$750 (for a single person in 1992). The maximum monthly amount changes annually. Countable income is defined in 20 CFR §§416.1100-416.1104, as *all* income including "earned and unearned income." Receipt of property other than cash is treated as a receipt of income in the month the property is received if the property can be liquidated or converted to cash. The receipt of in-kind support and maintenance (ISM) (generally, food, clothing, and shelter) is also treated as a receipt of income. These rules are significant when planning trust distributions and are explained in greater detail later in this article.

SSI gives recipients a monthly cash payment. This payment supplements other income (if any) in order to bring the recipient's total income up to the specified level. Accordingly, the benefits are immediately reduced when the beneficiary receives cash or countable in-kind assistance from any source. "Income" for SSI purposes is not limited to *taxable* income. The beneficiary must report receipt of cash or in-kind assistance within 10 days following the month of receipt. Changes in status (address, household configuration, and marriage) must be reported as well. See Reporting Obligations, below.

Resource Requirements

Recipients may own nonexempt "resources" (assets) having a value of less than \$2000 (\$3000 for a married couple). 20 CFR §416.1205. Countable resources (also called assets or property) are all resources that are "available" and not otherwise "exempt." 20 CFR §416.1201.

Resources that are not available. If an applicant "owns" property that cannot be legally liquidated or converted to cash for the applicant's support, such property cannot be deemed "available" and therefore will not be counted in the resource limit to determine the person's eligibility for SSI. 20 CFR §416.1201(a)(1). Such an impediment to liquidation is strictly interpreted. A certificate of deposit with a 25 percent early withdrawal penalty is *not* legally unavailable. If property is "unavailable," it is not counted for eligibility purposes for only as long as the impediment to "availability" continues to exist.

In the context of this article it is important to note that

the SSI Program Operations Manual System (POMS), which are the published guidelines used by the Social Security Administration in administering the SSI program, provide that principal of a trust is not a "countable resource" as long as the beneficiary does not have the authority to revoke the trust and use the principal for his or her support and maintenance. POMS 01120.200.

"Retaining Medi-Cal eligibility is usually essential for special needs trust beneficiaries."

Resources that are exempt. Exempt resources are those not counted against eligibility because they allow the applicant a minimum level of financial security. 20 CFR §§416.1210-416.1238. If property is "exempt," it is not counted even though it could be liquidated and would therefore be "available." The most important exempt asset is a home. 20 CFR §416.1212. Nonexempt resources are any other funds, property, or assets not classified by the program as exempt. Cash, stocks, bonds, and nonresidential real property are not exempt. A listing of exempt resources appears below following the discussion of Medi-Cal.

Medi-Cal

Medi-Cal is a health care benefit available primarily to individuals with low incomes and few assets. Benefits are paid directly to the health care providers who serve the "recipients." The eligibility rules are found at 42 USC §§1396a-1396g, 42 CFR §§435.700-435.740, and federal guidelines issued by the Health Care Financing Administration. State regulations are contained in Cal Code Regs §§50000-59999, and policy guidelines are found in All County Letters issued by the California Department of Health Services (DHS) on an almost weekly basis.

Retaining Medi-Cal eligibility is usually essential for special needs trust beneficiaries. Most have high health care expenses, and it is unlikely that they will be able to obtain private health insurance if they have severe disabilities. Thus, if the beneficiary is not eligible for Medicare benefits, the trust funds would probably be depleted by medical expenses. Medi-Cal is especially important because of its comprehensive coverage. Among other things, it pays for prescription drugs, out-patient care, hospital care, and care in skilled nursing facilities.

In California, there are two ways to qualify for Medi-Cal. One is to become "categorically eligible" by qualifying for federally funded programs such as Aid to Families with Dependent Children (AFDC) or SSI. The recipients

of these programs are automatically eligible for Medi-Cal. Persons may also qualify for Medi-Cal if they are "medically needy," meaning that they meet the "status" criteria for SSI or AFDC, *i.e.*, they are aged, blind, or disabled, or a family with dependent children, and meet the resource limits for those programs, but have income exceeding the applicable limits.

The "medically needy" are eligible for Medi-Cal benefits after they incur a certain amount of medical expenses in a month. This amount, referred to as the "share of cost," is calculated by subtracting a subsistence level "maintenance need allowance" from the recipient's total income during the calendar month. The share of cost is considered by Medi-Cal to be available to pay medical expenses and functions as a monthly deductible. The applicant must incur medical expenses in this amount each month before a Medi-Cal card is issued to the recipient. Proof of payment of the expenses is not required.

The eligibility rules applicable to the "medically needy" closely parallel the SSI rules. Medi-Cal benefits are also reduced when the beneficiary receives "income." Income under Medi-Cal rules is similar to that defined under the SSI rules. The reduction in the Medi-Cal benefit is usually accomplished by requiring the recipient to pay a higher share of the medical expenses. At some point, the share of cost is so high that an applicant is effectively ineligible. The reporting requirements for the medically needy are substantially the same as for SSI recipients.

SSI and Medi-Cal Resource Exemptions

The Medi-Cal and SSI exempt-resource rules are similar, but not identical. Important exempt resources are:

1. *The principal residence of the recipient*, if the recipient, a spouse, or a disabled or a minor child lives in the home or if the recipient *intends* to return to live in the home. Welf & I C §14006(b)(2), (c); 22 Cal Code Regs §50425(c)(3); 20 CFR §416.1212(c).

2. *One automobile*. For SSI purposes, the car must have a value below \$4500, or it must be used for transportation for treatment of a specific medical problem. For Medi-Cal purposes, any car of any value which is used for transportation is exempt. 22 Cal Code Regs §50461; 20 CFR §416.1218.

3. *Household goods and personal effects* are totally excluded for Medi-Cal purposes. SSI allows the exemption of up to \$2000 of equity in household goods and personal effects. 22 Cal Code Regs §50465; 20 CFR §416.1216.

4. *A wedding ring and engagement ring*. 22 Cal Code Regs §§50043, 50467; 20 CFR §416.1216(c).

5. *Whole life insurance up to \$1500 face value*. 22 Cal Code Regs §50475; 20 CFR §416.1230.

6. *Term life insurance*. 22 Cal Code Regs §50475 (by implication); 20 CFR §416.1230.

7. *A prepaid burial plan* if it is carefully structured under Medi-Cal rules to comply with 22 Cal Code Regs §50479 and All County Letter No. 90-14. Section 50479 provides that Medi-Cal recipients may keep \$1500 in a designated burial fund, and \$1800 in an irrevocable fund. SSI limits the exemption to \$1500. 20 CFR §416.1231(b).

8. *Burial plots and vaults*. 22 Cal Code Regs §50477; 20 CFR §416.1231(a).

9. *Musical instruments* are exempt under Medi-Cal rules. SSI counts them against the \$2000 household furnishings and personal effects allowance. 22 Cal Code Regs §50471; 20 CFR §416.1216.

Veterans Benefits

The major veterans benefits are:

1. *Veterans compensation*. These are cash grants available to veterans (and in some cases, their dependents), whose disability is due to a service-connected disease or injury.

2. *Veterans pensions*. These are cash grants payable to financially needy, totally disabled wartime veterans.

3. *Veterans health care services*. Service-connected veterans may receive in-patient hospital and other health services from the Veterans' Administration. Low-income non-service-connected disabled veterans who are medically needy may receive services, to the extent they are available. These services can include nursing home care, home care, or domiciliary care.

These benefits are available only if the applicant meets the standards for classification as a veteran. To assist your clients with such a determination, clients should be advised to contact the local Veterans' Service office. Most counties provide this as a free service to residents because legal services are limited for veterans. This limit is based on the rule that an attorney may not charge a fee for representing veterans in the application process until after the Board of Veterans' Appeals has issued a decision. 38 USC §5904(c)(1).

Subsidized Housing Programs

There are a wide variety of subsidized housing programs; they include public housing, Section 8 (certificate and project-based), Section 236, and Section 221. All these programs base admission on the resident's income and most base the amount of rent due or subsidy available on income. Loss of a housing subsidy can be very harmful to a tenant because it is often difficult to be reinstated. Although these programs do not have a resource limitation as do SSI and Medi-Cal, the tenant's resources are

relevant because these programs use the actual income generated by "countable" assets or imputed income from assets that exceed \$5000. The HUD Handbook is not nearly as specific as the SSI or Medi-Cal regulations. It provides that assets do not include "necessary personal property" (clothing, furniture, cars, etc.), life insurance, and assets that are not accessible to the applicant and that provide no income to the applicant.

"Unfortunately, this result can be dictated by some trust instruments, in which case the trustee might consider seeking reformation of the trust instrument."

The Handbook provides that "principal value of any trust available to the household" is counted; however, it goes on to state that "irrevocable trusts—i.e., ones that no family member can control" are not counted.

Distribution Strategies

Once the trustee has determined the available benefits and applicable eligibility rules, the trustee must determine suitable ways to apply trust assets to improve the life of the beneficiary. Generally, the trustee will wish to avoid taking actions that result in lost or reduced eligibility for public benefits, except when the lost benefits are relatively small compared to the benefits that can be funded from the trust estate. (If the trust estate is large, it might be inappropriate to make only modest distributions in order to preserve public benefits. Unfortunately, this result can be dictated by some trust instruments, in which case the trustee might consider seeking reformation of the trust instrument.)

The benefits that will most commonly cause eligibility problems for the trustee are SSI and Medi-Cal and the following discussion is addressed to those benefits.

Avoiding Cash Distributions

A cash distribution from a special needs trust to the beneficiary will be treated as income in the month of distribution and cause a dollar-for-dollar reduction in the beneficiary's SSI. Trust and income tax rules pertaining to principal and income are irrelevant. If the income threshold is exceeded, there may be a complete loss of Medi-Cal or at least an increased share of cost (the monthly deductible described above). If the cash is not consumed by the beneficiary or used to purchase exempt resources, the cash will count as a resource in subsequent months.

Planning Distributions To Avoid or Minimize "Income"

Given the undesirable impact of direct cash distributions to the beneficiary, the trustee needs to consider such transactions as: distributions of exempt assets, permitting use of property owned by the trust, and provision of services and goods to the beneficiary by making direct payments to third party vendors. In this context, it becomes important for the trustee to understand rules applicable to "in-kind" income.

Treatment of Unearned "In-Kind" Income

Generally, for purposes of SSI and Medi-Cal, income often remains income notwithstanding the fact that the income is in a form other than cash, but this is not always the case.

Property distributions causing "income." Under SSI, there are two kinds of unearned in-kind income: ISM, which is food, clothing, or shelter the person is given or that is received because someone else pays for it, and "other unearned in-kind income," which is a receipt of property other than food, clothing, or shelter. ISM is treated as income for eligibility purposes. "Other unearned in-kind income" is not necessarily treated as "income" if the recipient cannot reduce it to cash. POMS 835.130.

► **EXAMPLE:** The trustee purchases an airplane ticket for Mary, so she can visit her sister. The trustee pays for the ticket with a credit card. If Mary sells or transfers the ticket, she will violate the Federal Aviation Act. Therefore, Mary cannot convert the ticket to cash and the ticket is not treated as income. If the ticket could be converted to cash, it would be considered "other unearned in-kind" income.

"Valuation" of in-kind support. When ISM is treated as income, the amount of the income, for eligibility purposes, is not necessarily the fair market value of the goods and services received nor the cost of the property to the trustee or other provider. There are two rules for determining the value of ISM: (1) the one-third reduction (VTR) rule, and (2) the presumed maximum value (PMV) rule.

If the VTR rule applies, the *federal portion* of the beneficiary's SSI benefit will be reduced by one third if the recipient is provided ISM *regardless* of the actual value of the ISM provided. 20 CFR §416.1131. This currently results in a reduction of \$161. The rule applies if the beneficiary is considered to be living in another person's household and receives both food and shelter from the household.

If the PMV rule applies, the SSI benefit will be reduced by the same amount (*i.e.*, one third of the federal benefit plus \$20 (\$161 in 1992)), but the recipient can rebut the presumed value of the ISM if the actual value is lower. 20 CFR §416.1140. This is the applicable rule if the beneficiary lives in his or her own household or lives in another person's household but does not receive food from the household. 20 CFR §416.1141, POMS 835.200.

Items treated as ISM. The following household costs are treated as ISM for SSI purposes: mortgage payments (including property insurance if required by the mortgage holder); rent; real property taxes (less any tax rebate/credit); heating, gas, electricity, water, sewer, garbage removal.

Items not treated as ISM. The following household costs are not treated as ISM for SSI purposes: telephone, television cable, condominium fees (except to the extent these might include such things as garbage removal), and property insurance held at the owner's or renter's option.

Treatment of In-Kind Income: Medi-Cal

The Medi-Cal ISM rules are significantly different. For Medi-Cal purposes, in-kind income is only considered income if the *entire item of need* is provided. 22 Cal Code Regs §50509(b). Items of need include housing, utilities, food, and clothing. Thus, for example, the trustee can pay a portion of the rent of the beneficiary without increasing the beneficiary's Medi-Cal share of cost.

Section 8. Section 8 housing also has different rules. For example, the HUD Handbook states that groceries provided by persons not living in the household are not considered income. However, rent or utility payments regularly paid on behalf of the family are income. These are the only two examples of "third party" vendor payments in the HUD Handbook. Presumably if the trustee's purchase of groceries for a beneficiary is not income, the payment of other "nonshelter" expenses would not be income either.

In-Kind Distribution Strategies

The foregoing rules suggest some obvious strategies:

1. Provide the beneficiary with property and services that cannot be converted to cash and that are not considered ISM by making direct vendor payments, *e.g.*, for experimental or alternative medical treatments not covered by Medi-Cal, travel, education, newspaper subscriptions, transportation, dry cleaning, and personal care and home care services. However, if the trustee determines that the beneficiary has food, clothing, or shelter needs that are not being adequately met, the trustee may decide to make distributions for food, clothing, or shelter, understanding that this will reduce the beneficiary's SSI. If the actual

value of the ISM is greater than the PMV, SSI benefits will be reduced only by the PMV. For example, if the trustee paid rent of \$1000 and made purchases of \$200 in groceries and \$150 in clothing all in one month, the SSI benefits in that month would only be reduced by \$161.

"Lump countable distributions into a single month."

2. Lump countable distributions into a single month. If the trustee wishes to provide the beneficiary with assets that will be exempt as resources (*e.g.*, a television set, other furniture, an automobile, etc.), but that will be income in the month of receipt because the assets can be converted to cash, the trustee may wish to acquire and distribute all the desired assets in a single month. This strategy probably will eliminate SSI and Medi-Cal eligibility, but only for the single month. This will result in an overpayment of benefits. SSI will seek recovery of the overpayment. Medi-Cal may not be able to issue an overpayment notice in sufficient time to generate an overpayment liability.

Avoiding Excess Resources

The strategies for avoiding excess resources should be somewhat obvious. They include:

1. Make sure transfers to the beneficiary are in the form of exempt resources or property that cannot be used to provide food, clothing, or shelter.
2. Avoid converting exempt assets into nonexempt resources. This can occur by conversion of an asset to cash or by failing to use an asset in a manner that maintains the asset's exempt status.
3. Avoid actions that make "unavailable" assets available (*e.g.*, retain title to property in the name of the trust).

Should the Trust Own the Home?

The last point raises the very significant issue of whether the trust should own a residence. Preserving the family home or maintaining a home for a disabled individual is frequently a primary goal of a settlor of a special needs trust, particularly when the settlor is the beneficiary's parent. There are at least four issues to be considered when the trust corpus includes a home or when the trustee proposes to purchase a home to be held by the trust.

Exempt status of residence if owned by beneficiary. A residence in which the recipient resides will be an exempt asset for Medi-Cal and SSI purposes. Further, under both these programs, if the recipient is not living in the home but has an "intent to return" home, the residence remains ex-

empt. Welf & I C §14006(b)(2), (c); 22 Cal Code Regs §50425(c)(3); 20 CFR §416.1212(c). Therefore, the trust beneficiary may own a residence, free of trust, without adversely affecting his or her SSI or Medi-Cal benefits. *However*, if the recipient owns the home, but the trustee of the special needs trust makes mortgage payments, or pays for utilities, taxes, or any other "shelter" cost, the payments may constitute ISM and cause a reduction in the SSI benefits. This is because POMS requires an ISM deduction whenever a third party payment from outside the household directly to a vendor results in the receipt of shelter. The question is whether a special needs trust is considered to be a "third party." An argument can be made that, because under POMS a trust beneficiary is considered to have an equitable ownership interest in trust assets and because the SSI recipient is the sole beneficiary of the special needs trust, the trust should not be considered a "third party."

Another problem here is that, even though the residence may be exempt during the recipient's lifetime, DHS may be able, in certain circumstances, to assert a claim against the residence on the death of the recipient for the amount of Medi-Cal benefits provided to the recipient. See Welf & I C §14009.5 and Postdeath Recovery, below.

Alternative of trust ownership. If a trust holds title to a residence and allows a beneficiary to live there rent free, is the trust providing ISM? If so, this will reduce or eliminate the benefits available to the recipient. Although this may seem to be the case, one can find support in POMS to avoid this punitive result. Under POMS, "rent-free" shelter is only found to exist when no household member has an ownership interest in the residence. POMS 835.370. POMS further provides that the beneficiary of a trust has an ownership interest in the trust property. POMS 01110.500, 01110.515(C)(2), 01120.200.

Tax Considerations. The typical special needs trust created by a relative is not likely to be a grantor trust which will be treated as owned by the beneficiary under IRC §§671-678. This may result in loss of certain tax benefits, including the right to roll over gain when selling a residence and buying a replacement (IRC §1034), and the \$125,000 gain exclusion (IRC §121). The result is less clear if a court establishes the trust under the new California statute in which the trust corpus is received as a result of a tort claim.

Other relevant considerations. There are other factors that may influence a trustee in making a decision as to whether to retain ownership of the residence or transfer the residence, free of trust, to the beneficiary. In particular, retention of the residence by the trust gives the trustee of

the trust control of the residence on the death of the beneficiary, and may insulate it from claims by government agencies. Further, the beneficiary may lack the capacity or the judgment to manage such a significant asset.

Reporting Obligations

The needs-based programs (SSI and Medi-Cal) have strict reporting requirements. Failure to report changes in the recipient's life or failure to report any new income or assets can lead to future ineligibility for benefits, reporting penalties and even charges of fraud. SSI rules require that the recipient report these changes within the first ten days of the month following the month in which the change occurred. Medi-Cal, however, requires that beneficiaries report any change within ten days of the change.

"Failure to report changes in the recipient's life or failure to report any new income or assets can lead to future ineligibility for benefits, reporting penalties and even charges of fraud."

A trustee of a special needs trust should never underestimate the importance of keeping the government agency apprised of important issues. In nonroutine public benefits situations, trustees are best advised to report, as required by the rules, and challenge any ineligibility determinations resulting from a proactive position, rather than be forced to react to an unanticipated notice of unfavorable action.

For example, the trustee will be confronted with issues of when and what to report with respect to creation of the trust, funding of the trust, and subsequent operation and distribution of the trust.

In each case, it is best to report *accurately and promptly*. If the agency denies or discontinues eligibility based on the trust or a trustee action, the recipient can plan for such a decision, prepare an appeal, and have the benefit of a relatively neutral forum for such an appeal. If there is failure to report and a subsequent discovery by the agency, the clients may be accused of fraud and become subject to civil or criminal penalties. This scenario results in the agency questioning the good faith of the recipient, and as a practical matter will negatively affect the pursuit of an administrative appeal. Further, contact with the frauds division of any public benefits agency can be an intimidating experience for any client.

Discovery of Failure To Report

The existence of unreported assets comes to the attention of the public benefits agencies in a number of ways,

but primarily the Income Eligibility Verification System (IEVS) matches Social Security numbers with routine reports of income filed on 1099 forms from banks and other financial institutions. A report of a match will be compared with the application. If, for example, interest income indicates the existence of a \$20,000 bank account, the agency will contact the applicant to find out why the account was not reported, whether it still exists, and if not the disposition of the funds. If the account is still available to the recipient, the recipient is ineligible because he or she has assets in excess of the allowable (\$2000) limit. If the funds were transferred, Medi-Cal may impose a period of ineligibility as a transfer penalty. In either event, the recipient may have received benefits for which he or she was ineligible. This is termed an "overpayment" of benefits. When a recipient is "overpaid," the recipient may be required to repay the agency. By reporting early and resolving the matter, such overpayment can be avoided.

It should be noted that the mere execution of an unfunded trust is not normally a reportable event. However, disclosure will normally be required once the trust is funded if the beneficiary is already receiving benefits. Depending on the terms of the trust, if the beneficiary is receiving any cash payments from the trust, or is receiving in-kind support, the receipt of such income must be reported. Even if no such payments are made, the existence of a funded special needs trust which names the recipient as a current beneficiary, and could, by its terms, make distributions of income or in-kind support to the beneficiary, will usually have to be reported in answer to questions on the application forms or during the annual interview or on the annual redetermination questionnaire.

Be prepared to provide copies of the trust instrument on request. The trustee may be required to attempt to "break the trust." See Responding to a Request by Medi-Cal To Petition To "Break the Trust," below.

Responding to "Notices of Action"

When a beneficiary reports any change in status, income, or assets, it is not unusual for the agency to issue a Notice of Action (Medi-Cal) or a Notice of Determination (SSI). These notices officially inform a client of a change in benefits. If a beneficiary receives any unfavorable notice, the beneficiary is entitled to the due process protection of a "fair hearing." *Goldberg v Kelly* (1970) 397 US 245.

To exercise this protection, the beneficiary, payee, or anyone acting for the beneficiary, must act immediately. The agency will continue to pay the customary benefit amount and suspend action to terminate the benefit if the applicant responds to the notice within a ten-day period.

The trustee must not be misled by the notice which states that the appeals period will be 60 days (SSI) or 90 days (Medi-Cal). These deadlines refer to the appeal *right*. However, unless there is an immediate request for such appeal, *benefits* will be terminated. After that, it may become necessary for the beneficiary to wait for months for the issue to be resolved. If the issue is resolved in the beneficiary's favor, benefits may be paid retroactively. However, this may be an extremely unsatisfactory result if benefits are terminated, and Medi-Cal health care insurance eligibility was lost during the period.

"The trustee must not be misled by the notice which states that the appeals period will be 60 days (SSI) or 90 days (Medi-Cal)."

For these reasons, practitioners must insist that their clients contact them whenever the client receives any notice of unfavorable action, or any action whatever that is unclear.

Appeals

If an appeal is necessary, the trustee should contact the agency to find out about the appeal process.

The steps in the SSI/SSA appeals process are to:

- Request a reconsideration;
- Request an appeal before an administrative law judge;
- Request a review by the appeals council;
- Initiate court action.

In addition, an SSI recipient may concurrently initiate a "Request for Waiver."

The steps in the Medi-Cal appeals process are to:

- Request a fair hearing;
- Request review by the chief administrative officer of the agency;
- Initiate court review.

Responding to a Request by Medi-Cal To Petition To "Break the Trust"

It is not unusual for a beneficiary or a trustee to receive a notice from Medi-Cal instructing him or her to petition the court to release trust funds. Only when such a petition is denied will Medi-Cal find the trust funds unavailable.

Medi-Cal relies on 22 Cal Code Regs §50489(b)(2) for the authority in making this request. However, under federal law, California cannot have Medi-Cal eligibility rules that are more restrictive than SSI rules. Because the SSI rules do not require such a petition in order to find that a trust is "unavailable," there is a strong argument that 22

Cal Code Regs §50489(b)(2) is more restrictive than the SSI rules and is therefore unenforceable. The authors have been informed that DHS is in the process of revising its regulations regarding trusts and this requirement to petition the court for release of funds may be eliminated.

Some trustees have preferred to comply with Medi-Cal's request to petition the court rather than contest the requirement at an administrative hearing. If the trust has been properly drafted, the request to release trust funds should be denied. However, the trustee is taking some risk that the court may actually order the release of trust funds.

Postdeath Recovery

After the death of a beneficiary, the trustee of a special needs trust may receive a government agency claim for reimbursement for the costs of the benefits received by the beneficiary. The Social Security Administration does not make any claim for reimbursement on the death of an SSI beneficiary, but DHS is more aggressive. Currently, DHS can only make such claims for correctly paid benefits on the death of a Medi-Cal beneficiary if the beneficiary was 65 or older when benefits were received and there is no surviving spouse, surviving child under 21 or surviving child who is blind or permanently and totally disabled. Welf & I C §14009.5(b). Medi-Cal recipients who win personal injury awards are subject to a different form of recovery of benefits. Welf & I C §14124.

The state's implementation of its recovery program was challenged in *Citizens Action League v Kizer* (9th Cir 1989) 887 F2d 1003, reported at 11 CEB Est Plan R 70 (Dec. 1989). The court ruled that California's practice of filing claims for reimbursement against property passing by joint tenancy violated federal Medicaid law. The court determined that federal law gave states the right to file claims against a deceased Medi-Cal beneficiary's estate and held that "estate" must be interpreted as the probate estate. However, DHS has continued to file claims against assets passing in trusts. This practice is likely to cause a court challenge.

However, the recent passage of Stats 1992, ch 355 (AB 3328—Horcher) may give the state authority to file claims against special needs trusts on the death of the beneficiary of a trust created under the new statute. The statute gives various state departments, including DHS, the State Department of Mental Health, and the State Department of Developmental Services, the right to file a claim against the trust on the death of the trust beneficiary or on termination of the trust. Prob C §3605(b). The trustee is required to notify the various departments of the death and the departments have four months after they receive notice to file a claim. Prob C §3605(c), (e).

This legislation raises several issues. First, notwithstanding the new statute, it would violate federal Medicaid law if DHS filed claims against trusts to recover benefits if the beneficiary was under age 65 when benefits were received. See 42 USC §1396p.

Second, it is unclear whether the statutory authorization granted to DHS would survive the test of *Citizens Action League* because the trust funds are not part of the beneficiary's probate estate.

Third, the statutory right to file claims only applies to special needs trusts established under Prob C §3604 on or after January 1, 1993. It does not apply to special needs trusts created without court approval, i.e., testamentary special needs trusts and special needs trusts created for mentally competent adults.

The issue of the state's right of recovery against special needs trust will continue to be murky and will most likely result in litigation. A trustee faced with a claim for reimbursement should carefully scrutinize the claim, require a full accounting of the claim, and consider a legal challenge to the state's right to make the claim.

DEVELOPMENTS

Federal Estate Tax

IRC §2032A: Special Use Valuation

Failure of spendthrift trust beneficiaries to sign recapture agreement is a curable defect. Court notes inconsistency in Conference Report example of curable defect.

Estate of McAlpine v Commissioner 92-2 USTC ¶60,109

Decedent devised his ranch to three spendthrift trusts, one for each of his three grandchildren, ages 9, 20, and 22. Their mother was designated as trustee. Each trust terminates and the remaining assets are distributed to the beneficiary when the beneficiary attains age 35. On the federal estate tax return, the executor elected special use valuation for the ranch. The mother, in her capacity as trustee, executed the required agreement consenting to personal liability for any recapture taxes which might be imposed in the event of future failure to use the ranch for a qualified use for ten years. The beneficiaries did not sign the agreement. On audit, the Service disallowed the election. Within 90 days after receiving notice from the