USING THIRD PARTY SNTs IN ESTATE PLANNING

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by

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1. Introduction

Once upon a time, if a family member suffered from a disability, it was common for traditional estate planners to draft documents that left that child's share to a sibling or other family member who would "take care" of the person with the disability, trusting the recipient to "do the right thing."

This type of planning was always fraught with peril: What if the "good child" decided not to "do the right thing?" The sibling with the disability had no recourse. Furthermore, as family units became more geographically diverse and divorce and re-marriage created family trees that looked more like briar patches than trees, the use of discretionary support trusts grew in popularity. However, with the advent of various means tested public benefit programs such as Supplemental Security Income (SSI) and Medicaid, persons with disabilities who would otherwise qualify for these benefits found themselves disqualified because the very discretionary support trusts that were designed to assist them rendered them ineligible for the public benefits.

As a result, a new type of trust was created known today as a "Special Needs" or "Supplemental Needs" Trust (hereafter "SNT"). These trusts essentially exist for one purpose and one purpose only: to make the corpus of the trust available for the beneficiary's "special needs" without disqualifying her from whatever public benefits to which she may be entitled now or in the future.

This paper will focus on issues and opportunities in the relationship between traditional estate planning and SNTs. After a brief overview of the types of SNTs that exist, we will focus on (a) the uses of Third Party SNTs in the estate planning context; (b) some of the ethical issues involved in drafting SNTs; (c) drafting distribution clauses for maximum flexibility; (d) methods of reforming or modifying trusts; and (e) dealing with issues specific to SNTs that arise on trust termination.

2. Basics of SNT Drafting

A. What Is A SNT?

A SNT is a type of irrevocable trust "that limits the trustee's discretion as to the purpose of the distributions" and has specific language restricting distributions so that the distributions "supplement, but not supplant, sources of income including SSI or other government benefits.[1]

B. Types of SNTs

Within the SNT drafting community, SNTs created with the intended beneficiary's own assets are generally referred to as "first party" trusts or "(d)(4)(A) Trusts"(referring to the federal enabling statute, 42 U.S.C. §1396p(d)(4)(A)). SNTs created with someone else's assets are referred to as "third party" trusts. In both cases "party" refers to the deemed legal ownership of the assets that will comprise the trust's corpus.

While the federal statute is the primary source of the statutory framework

[1]Social Security Program Operating Manual System (POMS) SI 01120.200B.13.

governing SNTs, state statutes also exist in this area as well.[2]

1. "First Party" or "(d)(4)(A)" Trusts

a. Basic Requirements

By law, a "(d)(4)(A)" SNT can only be created for the benefit of an individual who suffers from a disability and is under the age of 65 at the time the SNT is created. Further, it can only be created by a parent, grandparent, legal guardian or conservator of the beneficiary or by court order. Since the SNT, by definition, is going to be funded with the beneficiary's own funds, the statute creates a "disconnect" between the trustor/grantor of the SNT on the one hand, and the source of the SNT's corpus on the other. This is but the first of many anomalies that exist in the world of SNTs.

b. Litigation SNTs

Litigation SNTs usually arise in the context of a personal injury or medical malpractice case. The Plaintiff, either through settlement or judgment, is going to receive an award to compensate her for her injuries. The award may be in a lump sum, periodic payments over a period of time (a "Structured Settlement") or a combination of both. If the Plaintiff suffers from an ongoing, continuing disability of some sort, or because of age does not have the acumen to appropriately deal with the award, or as most frequently occurs, receiving an award

[2]See, for example Cal. Probate Code § 3604.

of such magnitude will have an adverse impact on the Plaintiff's ongoing public benefits, it is deemed to be in the Plaintiff's best interest that a SNT be created for her benefit. In many jurisdictions litigation SNTs are subject to court approval and ongoing court supervision.[3]

c. Non-Litigation First Party SNTs

Non-Litigation First Party SNTs arise in a variety of circumstances. Most often they are created where the intended SNT beneficiary receives a significant gift or inheritance during a period of time when she is receiving some form of means-tested public benefits such as Medicaid or SSI. Possession or retention of the gift or inheritance jeopardizes the ability to continue to receive the means-tested benefits. In appropriate circumstances the assets can be transferred to a SNT without incurring any loss of public benefits or, at worst, incurring a brief interruption in those benefits.

d. Spousal and Child Support SNTs

The corpus of a SNT may, (depending on state law), consist of spousal or child support. Under the Social Security Regulations, support is considered unearned income and can therefore adversely impact an individual's eligibility for public benefits.[4] Where the

[3]See, for example, Cal. Probate Code §3604 and Cal. Rule of Court 7.903

[4]20 C.F.R. §416.1121(b).

individual (whether former spouse or child) has a disability, consideration should be given to whether or not a SNT should be created within the dissolution proceedings to receive the support payments.[5]

2. Third Party SNTs

Third Party SNTs are those created for the benefit of a person with a disability that makes that person an appropriate beneficiary of a SNT and are funded with assets belonging to someone other than the SNT's beneficiary. The easiest example of a Third Party SNT is where parents of a child with a disability create, as part of their own estate plan, a SNT for the benefit of their child and provide in their estate planning documents that the child's share of the inheritance is distributed to the SNT rather than to the child directly.

[5]*See* Neal A. Winston, *Divorce American Style: divorce, Child Support, & SNTs - The Sequel,* Special Needs Trust X: The National Conference (CLE) Stetson Univ. College of Law Oct. 17, 2008; POMS SI 00830.455.C.1.a.

3. **SNTs and The Estate Plan**

A. Testamentary SNTs for the Surviving Spouse

1. For reasons that, to a certain extent, defy logic and definitely go beyond the scope of this paper, one spouse can transfer assets to a SNT created by her Will (*i.e.* a testamentary trust) for the benefit of the surviving spouse without the transfer being considered a disqualifying transfer for public benefit purposes, or the corpus of the testamentary trust being considered an available resource of the surviving spouse.

2. In a "conventional" estate plan, utilizing a revocable inter-vivos trust, the couple would ordinarily divide the assets on the first death into a "survivor's trust" and a "decedent's trust" or "exemption trust" (if there is an estate tax exemption available). If the surviving spouse is the beneficiary of the decedent's trust and that trust is structured as a support trust (*i.e.* the Trustee is authorized and directed to make distributions of principal and income for the "health, education, maintenance and support" for the surviving spouse), the decedent's trust would be considered an available resource of the surviving spouse for Medicaid purposes.

3. If however the trust provides that on the death of the first spouse to die his assets are transferred to the trustee of a testamentary special needs trust created by his Will for the benefit of his surviving spouse, the assets will not be countable assets for Medicaid purposes and will be shielded from estate recovery. This is because the statute specifically <u>includes</u> as available

resources assets transferred from one spouse to the other in a trust created "other than by Will."[6] The testamentary trust is a trust created by Will and therefore falls outside the statute.

4. If the revocable inter-vivos trust provides that the distribution is to the trustee of the testamentary trust rather than to the estate of the deceased spouse, the assets will not be subject to probate, which in some jurisdictions such as California can result in a significant savings in probate expenses.

5. As a result, the first spouse to die can leave his property in a SNT for the benefit of the surviving spouse regardless of age.[7]

B. Stand-Alone SNTs with *Crummey* Provisions

1. A Third Party SNT can contain *Crummey* powers so that the contributions to the SNT will qualify for the annual gift tax exclusion. The only difference between the use of *Crummey* Powers in the context of a SNT and an irrevocable life insurance trust (for example) is that the beneficiary of the SNT cannot be one of the holders of a *Crummey* Power since this would give her an immediate interest in the gift which could adversely affect her public benefit entitlements. Thus, under the rationale of *Estate of Maria Cristofani*[8] The *Crummey* Power holders should be the remainder beneficiaries of the SNT rather than primary beneficiary.

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[6]42 U.S.C. §1396p(d)(2)A)

[7]42 U.S.C. §1396p(d)(2)A), See for example 22 Cal. Code Regs. §50489.5(a)(1).

[8]97 T.C. 74 (1991) *acq*., 1992-1 Cum. Bull. 1, *acq*., 1996-2 Cum Bull. 1. See also, Zimring, Morgan, Frigon *Fundamentals of Special Needs Trusts* §3.03[a] (Matthew Bender).

C. Using Life Insurance and Retirement Benefits to Fund the SNT

1. Most parents, if asked how they would want their estate divided at death, would respond "equally among all my children." While this is a natural, loving response, it ignores the reality that a child with special needs will require a disproportionate amount of assets to maintain herself and probably will not have the wherewithal to generate such an amount on her own. In such cases making the SNT the beneficiary of life insurance provides an incredibly valuable tool in solving this conundrum.

2. Thus, the traditional irrevocable life insurance trust, long used as a vehicle to shelter the proceeds of life insurance policies can be drafted as a Third Party SNT.

3. Similarly, in situations where a disproportionate amount of the parents' wealth is in the form of a retirement plan or plans such as IRAs, Roth IRAs, 401(k) or 403(b) plans, the Third Party SNT can be designated as a "designated beneficiary" if the SNT is structured properly.[9]

[9] I.R.C. §401(a)(9). For a detailed discussion of the use of life insurance in SNTs and the application of the "designated beneficiary" rules to Third Party SNTs see Zimring, Morgan, Frigon *Fundamentals of Special Needs Trusts* §3.03[6], [7] (Matthew Bender).

D. Distributions From A Charitable Remainder Trust to a SNT

1. Clifton Kruse, in his treatise, *Third-Party and Self-Created Trusts* (3d ed.), analyzes IRS Revenue Ruling 76-270, 1976 C.B.-2 194 which inferred that a Charitable Remainder Trust (CRT) could make its distributions to a trust for the benefit of a disabled child.[10] In essence, this technique permits a charitably inclined individual to realize an immediate income tax deduction, receive income back and/or have the income stream paid to the trustee of a SNT. There are thus two instruments involved: the charitable gift annuity or CRT on the one hand, and the SNT (the receptacle trust) on the other.

In 2002, the IRS released Revenue Ruling 2002-20 which, by its terms, amplifies and supersedes Revenue Ruling 76-270. This new ruling explicitly validates the use of SNTs as receptacle trusts for distributions to a SNT. The facts of the Ruling stated:

> "An individual concurrently creates Trust *A*, a trust that otherwise qualifies as a charitable remainder unitrust, and a separate trust, Trust *B*. Under the governing instrument of Trust *A*, annual unitrust amounts will be paid to Trust *B* for the life of *C*. *C* is an individual who is financially disabled, that is, *C* is unable to manage *C*'s own financial affairs by reason of a medically determinable physical or mental impairment that can be expected to result in death or that has lasted or can be expected to last for a continuous period of not less than 12 months."

Situation 3 of the FACTS section of the Ruling states:

[10]Clifton Kruse, *Third-Party and Self-Created Trusts (3d Ed.)* Page 195, ABA 2002.

Situation 3. Under the governing instrument of Trust *B*, the Trustee may make distributions of income and principal, as determined in the trustee's sole and absolute discretion, for the financial aid and best interests of *C*. Upon *C*'s death, the governing instrument requires the trustee to reimburse the state for the total costs of medical assistance provided to *C* under the state's Medicaid plan. *C* is given a testamentary general power of appointment over the balance remaining in Trust *B*. If *C* fails to exercise the power, the balance will be distributed in equal shares, to *C*'s sister and to X*, a* charitable organization."

In its analysis, the Service states:

"In these situations, the use of the assets in Trust *B* during *C's* life and at *C*'s death is consistent with the manner in which *C*'s own assets would be used. *C*, therefore, is considered to have received the unitrust amounts directly from Trust *A* for purposes of §664(d)(2)(A). Accordingly, the term of Trust *A* may be for the life of *C* and is not limited to a term of years."[11]

Thus, If a charitable remainder trust is the primary vehicle, the payout language might read:

"In each taxable year of the Trust, the Trustee shall pay to [Disabled Person's] Special Needs Trust created to comply with Rev. Rul. 2002-20 as a permissible individual hereinafter referred to as 'the Recipient' during the Recipient's lifetime..."

[11]Rev. Rule 2002-20

Corresponding language in the SNT itself would read:

> "Trust Estate:
>
> The trust will be the receptacle for payment of a stream of payments from a Charitable Remainder Trust as described in Exhibit A, payable to the Trustee for the benefit of the beneficiary. Such stream of payments, together with any income and other accruals on the corpus, shall constitute the Trust Estate."

E. Pooled Trusts

1. A "pooled trust" or "(d)(4)(C)" SNT is a trust established and managed by a nonprofit entity. Individuals who are disabled can establish "sub accounts" but for purposes of investment and management of funds, the trust "pools" these accounts, hence the name.

2. Unlike (d)(4)(A) trusts, the individual with a disability can establish her own sub-account (in addition to a parent, grandparent, guardian/conservator or court order establishing the sub-account). And, depending on the jurisdiction, individuals over the age of 65 may be able to establish sub-accounts without the transfer constituting a disqualifying transfer for Medicaid purposes.

3. On the other hand, the statute gives the non-profit the right to retain for its general charitable purposes any funds remaining in the sub-account after the Beneficiary dies. While there is contention over this issue, it is the author's opinion that the (d)(4)(C) statute authorizes the charity to retain all assets remaining on the death of the beneficiary.

4. Some (d)(4)(C) Pooled Trusts provide that if the beneficiary wants, the beneficiary can provide that the state Medicaid Agency be reimbursed and thereafter, after payment of an agreed-upon percentage to the charity, the balance remaining can be distributed to remainder beneficiaries selected by the SNT beneficiary.[12]

5. Pooled trusts can be used as vehicles for third party funds as well, and in those cases are not subject to the reimbursement rules. This is an excellent alternative where the sums involved are relatively modest.

4. Basic Ethical Issues

A. Skill Level

1. There is an old joke about the man who was asked if he could play the violin. His answer was "I don't know; I haven't tried." An attorney wanting to enter the field of Special Needs Trust drafting or administration needs to know what she is doing. Not only is that plain common sense, it is at the core of the Rules of Professional Conduct governing the practice of law in every state. The very first rule of the ABA Model Rules of Professional Conduct, Rule 1.1 states:

> "A lawyer shall provide competent representation to a client. Competent representation requires

[12] 42 U.S.C. §1396p(d)(4)(C). For more information of Pooled Trusts generally, see www.sntcenter.org, the homepage of the Center for Special Needs Trust Administration, a non-profit organization that has pooled trusts in almost every state.

> the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."[13]

2. One of the first things a lawyer new to this area learns is that SNTs are different. The clients (whoever they may be), are often different and the issues are very different from those which the lawyer studied in Trust and Estates courses in law school. Competency in this area involves not just a knowledge of how to draft a trust. It involves knowledge regarding the peculiar ins-and-outs of public benefit programs such as Supplemental Security Income (SSI), a working knowledge of the Program Operating Manual System (POMS) of the Social Security Administration, regional variations within the Social Security System, the Medicaid rules governing the creation of SNTs, local Medicaid rules, Medicare rules, and, if that were not enough, some degree of knowledge in medicine, at least enough to be conversant with the special needs of the SNT beneficiary. These areas are going to vary from beneficiary to beneficiary.

3. Obviously, one new to this area of law will not possess these credentials. They are learned as one grows as a professional, but not at the expense of the client or the trust beneficiary. Thus, the message of MRPC 1.1 is that if the lawyer drafting or administering the SNT does not possess

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[13]ABA Center for Professional Responsibility, *2004 Rules of Professional Conduct* (hereafter "MRPC", found at http://swww.abanet.org/cpr/mrpc/mrpc.home.html. Rule 1.1 See also the National Academy of Elder Law Aspirational Standards (hereafter "NAELA Aspirational Standards"), 2 NAELA Journal 5 (2006), Standard D. These Aspirational Standards supplement and build upon each state's rules of professional responsibility, seeking to elevate and enhance the quality of service provided to the clients.

the necessary expertise, that lawyer has a professional obligation to consult with lawyers or other experts who do have the requisite skill and knowledge. Some states incorporate this requirement in their Rules of Professional Conduct. California's Rule of Professional Conduct 3-110(C), for example, states:

> "If a member does not have sufficient learning and skill when the legal service is undertaken, the member may nonetheless perform such services competently by 1) associating with or, where appropriate, professionally consulting another lawyer reasonably believed to be competent, or 2) by acquiring sufficient learning and skill before performance is required."[14]

4. Failure to do so is not only a violation of the MRPC, thereby potentially subjecting the attorney to disciplinary proceedings, but possibly malpractice as well.

B. Malpractice Issues - It Really Is Rocket Science

Two basic aspects of the malpractice issue will be discussed here: (1) malpractice by the SNT attorney in the drafting of the SNT and representation of the client and beneficiary on the one hand; and (2) malpractice by the litigation attorney (or other attorneys/professionals) in the handling of the matter in general.

1. Drafting Issues

a. Failing to draft the trust properly probably constitutes malpractice in most jurisdictions. Failing to carry out the wishes of the

[14]California Rules of Professional Conduct 3-310(C).

Grantor (i.e. incorrectly naming the remainder beneficiaries) will also subject the SNT attorney to a malpractice claim.[15]

b. In some cases the error can be corrected by reformation of the trust instrument.[16] Some drafters include language permitting a "Special Trustee" or "Trust Protector" to amend the Trust to conform to changes in the law or other situations, and such provisions may be utilized (depending on state law and the nature of the error) to correct the defects in the trust.[17]

2. Errors by Others

a. Interestingly enough, a number of cases finding professional negligence on the part of attorneys and subjecting them to disciplinary proceedings involve the absence of SNTs. A number of courts and State Bar disciplinary Boards have found attorneys negligent in not using SNTs to protect the disabled person's assets by utilizing SNTs.[18]

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[15]See *Bucquet v. Livingston*, 57 Cal. App. 3d 914 (Ct. App. 1976) holding that various drafting issues were within the ambit of a reasonably competent and diligent practitioner and therefore trust beneficiaries who suffered because of a negligently drawn will had standing to sue drafter for malpractice.

[16]See Zimring, "Modifying Trusts; Fixing Problems," The Basics of Special Needs Trusts, Stetson University College of Law, (October, 2006) at 11. See also Davis, Dudek & Whitenack,"Trust Reformation", NAELA Symposium 2007.

[17]Id, at 4, 8, 9

[18]See for example *Bd. Of Overseers of the Bar v. Brown*, 2002 Me. LEXIS 190 in which attorney was suspended from practice for six months for failing to have an SNT drafted on behalf of his client. See also *Sanango v. N.Y City Health & Hospital Corp.* 6. A.D. 3d. 519 (2d. Dept. 2004) where the appellate court was held to have erred in ordering the remaining amount of a settlement paid to an infant's estate upon his death instead of to an SNT where the payments would not have jeopardized the infant's continued eligibility for Medicaid benefits.

3. These cases and disciplinary proceedings serve two useful purposes: (a) they give the SNT attorney cogent reasons to "Just Say No" when the litigation attorney (or sometimes the institutional trustee or structured settlement broker) asks "can you send me your form?" or "I drafted it myself this time - I used the "form" you used in the last case - would you check it over?"; and (b) they are equally persuasive reasons for why the SNT attorney should be drafting the SNT and not the litigation attorney.

5. **Distribution Clauses - An Evolving Area**

A. Introduction

1. 20 years ago SNTs were virtually unknown. The author drafted his first SNT in 1991. The issue then was simple: A SNT was needed that could shelter the assets of an individual with a disability so that person could receive Medi-Cal and In Home Supportive Services.

2. SNTs were such a radical concept at the time that the County Eligibility Worker disallowed the transfer into the SNT and deemed the funds to be available assets of the beneficiary. An appeal ensued and went to an Administrative Hearing. The Administrative Law Judge found that the SNT was void as against public policy. A Writ of Mandamus against the County and State followed and less than 24 hours before the hearing on the Writ, the State conceded that the SNT was valid.

3. Today, SNTs are so common that there is even a section in the "Dummies" book on estate planning about them.[19] However, how SNTs have been drafted and the types of situations in which they can be utilized has evolved and continues to evolve.

B. In the Beginning

1. Early SNTs were, from a trust law perspective, relatively basic, tightly proscribed, discretionary trusts. The discretion vested in the Trustee was simple and straightforward, what the author refers to as the "Biblical" language - "Thou Shalt Not":

> "No part of principal or income of this trust may be distributed for food, shelter or clothing, or to replace any public assistance benefits for which the beneficiary may be eligible through any county, state, federal or other governmental agency."

2. As Cynthia Barrett noted in her and Ruth Phelps' excellent presentation at the NAELA Symposium in Vancouver in 2001, "The strict SSI standard for distributions is very common, but has come to seem too restrictive in situations where the beneficiary is not receiving SSI, and is eligible for other programs with more liberal eligibility standards."[20]

3. However, this language had the advantage of clarity and simplicity.

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[19] www.dummies.com - look at the table of contents for "Estate Planning for Dummies".

[20] Cynthia Barrett and Ruth Phelps "Distribution Standards for the Special Needs Trust", NAELA Symposium, April, 2001.

Trustees knew exactly what they couldn't do. Of course, the issue of what they could do was somewhat up in the air (and continues to be so), but the border was clear.

4. It quickly became clear that SNTs had a utility well beyond the world of SSI/Medicaid eligibility and SNT drafting attorneys rose to the challenge. As a result, concerns over SSI/Medicaid eligibility were no longer the only focus of the Trustee's discretion in making distributions, and some brave souls even ventured into the forbidden territory of permitting discretionary distributions that might impact public benefit eligibility. As a result, trust provisions such as this began to appear:

> "Payment of In-Kind Support and Maintenance. Notwithstanding the foregoing provisions of subparagraph (__), if the Trustee, in the Trustee's sole and absolute discretion, determines after consultation with an attorney who specializes in government benefit law and estate planning for the disabled, that it is in the best interest of _____ to provide in-kind support and maintenance (food, clothing and/or shelter) to _____ from time to time, then the Trustee may do so as long as ____'s continued right to receive SSI, Medicaid, or IHSS, as the case may be, is not jeopardized and ____ continues to receive all benefits to which he is entitled. Under the current provisions of 20 CFR §1130, payment of in-kind support and maintenance will reduce ____'s SSI Federal Benefit Rate by one-third. As long as this reduction does not disqualify ____ from continued receipt of SSI, even if the SSI amount is reduced to $1.00, the Trustee may act to make payments of in- kind support and maintenance. The Trustee shall be held harmless from all

actions taken in making these distributions so long as _____'s SSI payments are reduced and not eradicated completely."[21]

Another, similar approach:

"Notwithstanding the above provisions, the Trustee may make distributions to meet the Lifetime Beneficiary's need for food, clothing, shelter or health care or other personal needs even if such distributions may result in an impairment or diminution of the Lifetime Beneficiary's receipt or eligibility for government benefits or assistance, but only if the Trustee determines (1) that the Lifetime Beneficiary's needs will be better met if such distribution is made, and (2) that it is in the Lifetime Beneficiary's best interests to suffer the consequent effect, if any, on the Lifetime Beneficiary's eligibility for or receipt of government benefits or assistance; provided however, that if the mere existence of the Trustee's authority to make distributions pursuant to this paragraph shall result in the Lifetime Beneficiary's loss of government benefits or assistance, regardless of whether such authority is actually exercised, this subparagraph shall be null and void and the Trustee's authority to make such distributions shall cease and shall be limited to purchasing supplemental goods and services in a manner that will not adversely affect the Lifetime Beneficiary's government benefits."

A third variation on the same theme:

"My Trustee may distribute to or for the

[21]Most of the clauses cited in this section are taken from Stuart D. Zimring, "*Distribution Clauses: A Smorgasbord of Options*," Stetson University College of Law, Special Needs Trusts IV, 2002. Credit to the particular author of a clause can be found in that presentation.

> benefit of the beneficiary those amounts of income or principal which my Trustee may determine in my Trustee's sole, absolute and unfettered discretion, to be appropriate, and my Trustee may choose to make no distributions whatsoever.
>
> My son is disabled, and will rely on public programs for much of his life. I will not always be there to help him and oversee his care. I know that he will have supplemental and special requirements, and a need for advocacy and oversight, which will not benefit by such public programs. I urge my Trustee in the exercise of his unfettered discretion to consider making distributions which give dignity to my son's life, and permit him the highest development of his abilities and enhance his day-to-day existence."

5. In each of the clauses quoted above, the intent of the drafter is to enable the Trustee to make distributions that may impact the SNT beneficiary's public benefit entitlements, but only if it is done knowingly, having weighed the pros and cons of such action. The purpose is two-fold: (a) to expand the Trustee's distribution authority so long as it is exercised in the Trustee's fiduciary capacity after considering other available alternatives; and (b) to shield the Trustee from exposure for having made the decision.

6. Perhaps the most concise clause the author has seen that clearly focuses on these two intentions is the clause drafted by Sterling (Terry) Ross of California, in the chapter on SNTs he and Ruth Phelps authored for California's Continuing Education of the Bar treatise on Irrevocable Trusts. That clause reads as follows:

> "Although the intent of this trust is to preserve the beneficiary's eligibility for public benefits, the overriding goal of the trust is to ensure the beneficiary's good health, safety, and welfare. Consequently, the availability of public benefits to pay for a specific need shall not deprive the trustee of the authority, in the trustee's discretion, to make distribution of trust assets for the specific need, even if the distributions cause the loss of public benefits."[22]

C. The Challenge of the Shifting Landscape

The are at least four (4) areas in which change can be expected:

- Changes in the law
- Changes in the economy
- Changes in governmental policy
- Changes in the beneficiary's condition or status.

1. Changes in the Law

a. Health Care Coverage

i. What do the drafters do when there is some form of universal health care coverage that provides health insurance for SNT beneficiaries that is not means tested?

ii. This paper is being written in October, 2010. Implementation of the Patient Protection and Affordable Care Act is spread out over the next eight years (at least), it is

[22] John R. Cohan and Marc M. Stern, editors *Drafting California Irrevocable Trusts* (3d ed.), Oakland, 2001.

impossible to predict what will ultimately happen other than something will happen. If SNT beneficiaries who were previously covered by Medicaid are now covered by some form of universal health care insurance which requires they choose a form of coverage in the same way Medicare recipients can choose Medicare Advantage Plans (or not), but do need to choose a Medicare Part D drug plan, and must pay a premium of some amount, is this going to be a permissible distribution under the SNT? What about deductibles? Supplemental Insurance (*a la* "Medigap" policies)? Long Term Care Insurance offered as an "add-on" to the Universal Coverage?

iii. Obviously, how the Trustees of existing SNTs are going to address this issue will depend on the SNT's specific language. But on a "go forward" basis, it is suggested drafters consider adding clauses such as:

> Trustee's Authority to Enroll Beneficiary in Health Insurance Programs: In the event the Beneficiary is eligible to participate in a health insurance program or programs other than Medi-Cal, or is required to select and enroll in a health insurance program other than Medi-Cal, the Trustee is authorized to select a program appropriate for the Beneficiary and to pay the premiums for such insurance. The Trustee may exercise its authority under this paragraph even if Medi-Cal is still an available option to the

Beneficiary if the Trustee, in the Trustee's sole and absolute discretion, determines it is in the Beneficiary's best interest to do so.

"Health insurance program" includes (but is not limited to), "traditional" health insurance policies, group health insurance programs, health insurance cooperatives or exchanges, drug or pharmaceutical programs or any other program or policy that, in the opinion of the Trustee, provides a level of benefits or care equal to or superior to the public benefits programs for which the Beneficiary is eligible.

b. Medicare Set-Aside Arrangements

i. Another area of immediate interest involves Medicare Set-Aside Arrangements. SNTs arising out of litigation where Medicare has been involved in a Secondary Payor status may now be required to create Medicare Set-Aside Arrangements similar to those that have been used in Worker's Compensation Cases.[23] While this fact may be known at the time the SNT is being created, drafters may want to consider granting the SNT Trustee authority to create a sub-trust or separate account to be treated as a Medicare Set-Aside Arrangement in the future, even if it is not done at the time the SNT is created.

[23]Medicare's interest as a Secondary Payor is protected under 42 USC §1395y(b)(2). In the past, Medicare's status as Secondary Payer has primarily arisen in the Worker's Compensation area. However, under the Medicare, Medicaid and SCHIP Extension Act of 2007, additional reporting requirements were mandated that are being interpreted in many quarters as possibly requiring MSAs in liability cases as well as Worker's Compensation cases.

2. Changes in the Economy

a. The current (March, 2010) state of the economy throughout the United States is causing state governments to severely curtail existing public benefit programs. For example, in California, the State supplement for SSI benefits has been reduced, payment for dental care under Medi-Cal has been eliminated, and the hourly wage paid to care-givers under the In Home Supportive Services program has been reduced.[24]

b. As a result, benefits that SNT beneficiaries were previously receiving are no longer available, at least for the moment. Is it permissible in such circumstances for the Trustee to make distributions from the SNT to cover the newly-created shortfalls? If the trust language is similar to those quoted above with "permissive" language, the answer is probably "yes." However, a prudent Trustee, especially an institutional trustee (which is a "prudent trustee" to the Nth degree by definition), may not be comfortable with the "probably" portion of the equation. Should language like this be included in the future?:

> "During any period of time when a public benefit program the Beneficiary was receiving is curtailed, suspended or reduced, the Trustee, in the Trustee's sole and absolute discretion, may obtain similar benefits from alternative sources

[24]George Skelton, *Nightmares Come True for the Neediest*, Los Angeles Times, B1, June 8, 2009.

and pay for such benefits from the SNT. The authority of the Trustee under this section shall terminate at such time as the curtailed, suspended or reduced benefits are restored to their previous levels."

c. Further, if the Trustee does make distributions to cover the short fall and the public benefit funding is subsequently restored, has the Trustee created a situation where the public benefit agency may claim that the Trustee has created a precedent that it is appropriate for the SNT to pay for a particular benefit and the State agency is no longer responsible to do so?

d. Obviously, the argument in such cases will be that the SNT Trustee is fulfilling the terms of the SNT, *i.e.* to <u>supplement</u> the benefits provided by the various public agencies, not supplant them; and if the State agency is not providing those benefits at a given point in time, then the SNT, by definition, cannot be supplanting them. Unfortunately, too many of us have seen circumstances where the State agency takes a position that is not necessarily rational or consistent with centuries of established trust law and an issue that ought not to be litigated but for the economic exigencies of the moment, is litigated out of perceived economic necessity. More unfortunately, SNT Trustees may find themselves weighing the potential for litigation (or the threat thereof) against the needs of the

SNT beneficiary in a given situation.

3. Changes in Policy

a. The issues involved in a change in agency or programmatic policy are identical to those involved in the change in the economy discussion above. The difference is that changes in policy are permanent in nature whereas the changes in economic condition discussed above are hopefully temporary. Because of the permanent nature of a policy change, the approach of the SNT drafter and the SNT Trustee may be somewhat easier. For example, in the area of drafting for changes in the tax laws, estate planners have for years used clauses that permit Trustees to amend the administrative portions of otherwise irrevocable trusts such as this clause frequently used in Qualified Personal Residence Trusts (QPRTs):

> "This trust is irrevocable and may not be altered or amended. Notwithstanding the preceding sentence, the trustee shall have the power, acting alone, to amend the trust to the extent provided in Treasury Regulation §25.2702-5(a)(2) (or any subsequent regulation or statute) in any manner required for the sole purpose of ensuring that the trust qualifies as a qualified personal residence trust for purposes of Internal Revenue Code §2702(a)(3)(A) and Treasury Regulation §25.2702-50(c). "

b. Especially in irrevocable trusts, such clauses give the drafter and the Trustee a flexibility that belies the "irrevocable" nature of the document as a whole. Similarly, SNTs can use clauses such as the

following to give them added flexibility:

> "This Special Needs Trust is irrevocable and may not be altered or amended except as provided herein. Notwithstanding the preceding sentence, the Trustee shall have the power acting alone, to amend the Trust to as necessary and appropriate to maintain the Beneficiary's eligibility for all public benefit programs to which the Beneficiary is or may be entitled and/or to maintain the Trust's status as an exempt resource for any and all public benefit programs."

4. Changes in the Status of the Beneficiary

a. Perhaps the most intriguing and challenging area of change is that of the beneficiary herself. A significant number of the SNTs the author has drafted in the last year or so have been for families where the SNT beneficiary is a young child suffering from some form of Autism. In several of these cases the child is too young for the health care professionals to accurately diagnose the severity of the disease. In others there is some hope that he or she may "outgrow" it or that the symptoms may recede over time. In all cases there is the hope that treatments, therapies or drugs may be developed that will enable the beneficiary to live a normal (or almost normal) life. If that occurs, if the SNT beneficiary no longer suffers from a "disability," or the disability has been controlled/cured to the point where the restrictive nature of the distribution scheme of the SNT is no longer required, what can be done?

b. The most comfortable answer at the moment is an "upstream

distribution." In most of these cases the overall planning strategy for the family is a conventional Inter Vivos Trust for the parents, which divides into appropriate sub-trusts on the death of the first spouse.

c. On the death of the surviving spouse, the remaining Trust Estate is divided between the children/grandchildren, with the share of the child suffering from a disability going into a SNT for her benefit. Where lifetime gifting is anticipated or inheritances for the children may be coming from grandparents or others, the SNT would already be in place and free-standing. If it is to be totally funded by the inheritance from the parents, it may be created within the parents' overall plan as a sub-trust.

d. In either case, the parents' estate planning documents create conventional support trusts for the children as sub-trusts. One of these trusts is a "dry trust" for the benefit of the child with a disability.

e. The SNT contains a provision that the Trustee, a Special Trustee, the Trust Advisor or the Trust Advisory Committee may, in its sole and absolute discretion, distribute all or a portion of the SNT's assets to this other trust. Thus, if the party with the appropriate authority believes the SNT is no longer needed, that party can direct the SNT's assets to the support trust, which is still a discretionary trust, but with much broader and more liberal guidelines.

f. A typical clause is:

Termination: This Trust shall cease and terminate upon the first of the following to occur: Depletion of its assets; The death of the beneficiary; or The election by the Special Trustee to contribute the Trust assets (or a portion thereof) to the Trustee of the Fred Flintstone 2006 Trust to be held, administered, and distributed pursuant to its terms.

Distributions: If terminating by reason of the death of the Beneficiary, the Trustee shall distribute any remaining principal and income to the issue of Fred Flintstone who survive him by a period of thirty (30) days. If no such issue survive Fred by a period of thirty (30) days, then, in that event, the Trustee shall distribute any remaining principal and income to the Settlors' other children (i.e., to those children born to or adopted by the Settlors jointly). If any of them fail to survive the Beneficiary by a period of thirty (30) days, the gift to that deceased child shall lapse and be distributed to his or her issue by right of representation, or if he or she leaves no issue, then to the Settlors' other issue by right of representation, or, if there are no other issue, then, the Trustee shall distribute any remaining principal and income to the UCLA School of Law to be used to promote the care and feeding of aging Elder Law Attorneys.

In lieu of making distributions directly to any of the beneficiaries referred to in this Section b., the Trustee may, in the Trustee's sole and absolute discretion, distribute a beneficiary's share to an existing Trust created for the benefit of that beneficiary, if the Trustee, in the Trustee's sole and absolute discretion, determines that it is in the beneficiary's best interest to do so.

Powers of Special Trustee: The Special Trustee named below may, at any time, direct all or any portion of the Trust Estate be distributed to the Trustee of the Fred Flintstone 2006 Trust to be

held, administered, and distributed pursuant to its terms. Any portion not so appointed shall be held, administered and distributed pursuant to the terms of this Trust.

Termination Because of Ineligibility: Notwithstanding anything to the contrary contained in the other provisions of this Trust, in the event the Trustee's discretionary right to invade Trust principal for the Beneficiary herein has the effect of rendering the Beneficiary ineligible for Supplementary Security Income (SSI), Medi-Cal, subsidized housing or other, similar governmental benefits, the Trustee is authorized to terminate the Beneficiary's interest in this Trust, and the undistributed balance of the Trust Estate shall be distributed to the Trustee of the Fred Flintstone 2006 Trust, to be held, administered and distributed according to its terms. If either of the Settlors is serving as Trustee, that Trustee shall not have the power to terminate this Trust, but such power shall rest in the Special Trustee, who shall serve as Trustee for the sole purpose of exercising that power."

6. REFORMING TRUSTS; FIXING PROBLEMS

A. Introduction

1. This section will discuss those situations where, for whatever reason, the SNT language (or the language of a conventional trust that ought to have been a SNT) needs to be reformed or modified in order to qualify the trust as a SNT. This frequently occurs when the estate planning attorney "inherits" a plan drafted by another attorney who either was not aware that one of the intended beneficiaries suffered from a disability or worse, was aware, but did not draft the SNT properly.

2. SNTs are usually drafted as “irrevocable” trusts.[25] In the First Party SNT context, this is to satisfy the requirement of 42 U.S.C. §1396p(d)(4)(A) which requires such self-settled trusts to be “...established for the benefit of such individual...,” the argument being that if the trust were revocable, the settlor could revoke the trust or utilize its assets for the benefit of someone other than the beneficiary.

3. Unfortunately, an uncritical analysis of this strategy leads many drafters (and even more unfortunately, some interpreters), to the conclusion that because the trust is irrevocable, it is un-modifiable and therefore the beneficiary and the trustee are locked into the trust’s seemingly immutable provisions, regardless of whether those provisions are appropriate to the then-existing circumstances.

4. Fortunately, this is not true. As seen above, proper drafting can obviate the draconian consequences of “irrevocability” equaling “unmodifiable” and, even better, current trust law in most jurisdictions establishes statutory bases upon which interested parties can obtain judicial relief.

B. Modification

1. When & Why

a. As noted above, a properly drafted SNT (whether First Party or

[25]See generally Clifton B. Kruse, Jr. *Third-Party and Self-Created Trusts*, Third Edition (ABA 2002).

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

b. On the other hand, many older SNTs and those drafted by inexperienced draftspersons do not contain provisions permitting modification. Unfortunately, it is these trusts, more than others, that frequently are in need of modification in order to "fix" problems that have arisen because of unanticipated situations. These situations can involve the status of the trust's beneficiary, changes in the law, changes in the situs of the trust or changes in the trust's corpus. In all of these cases, "fixing" the "problem" will probably involve modifying or sometimes revoking the trust.

c. The issue of distributions that might impact public benefit entitlement is only one part of the dilemma/challenge SNT drafters face. The elimination of "clothing" as a restricted category is the tip of the iceberg of another challenge.[26]

d. What did the attorneys for the Trustees say to their clients regarding this issue? If the SNT specifically prohibited distributions for

[26]Effective March 9, 2005, 20 CFR §416.1102 was changed to eliminate "clothing" as an item that would result in reduction of SSI benefits if paid for by an outside source.

"food, clothing and shelter" but it was now permissible to purchase clothing without adversely impacting the beneficiary's public benefit entitlements, could the Trustee now buy clothes or was it still forbidden? As a general rule the author advised his Trustees that they could buy clothing for their SNT beneficiaries regardless of the SNT's specific language, but some institutional trustees definitely balked at the idea.

e. In cases such as these, does it make sense to seek judicial modification of the SNT (assuming such course is available under state law)?[27] In this particular example, it would probably not be economical to do so, but other situations might suggest a different answer. And those situations may well increase in number.[28]

2. The Restatement Position

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

> "The Settlor of an inter vivos trust has the power to revoke or modify the trust to the extent the terms of the trust so provide[29]
>
> If the Settlor fails to expressly make provision for revocation or amendment, the question is one of

[27]See for example Calif. Probate Code §15409.

[28]See also, Stuart D. Zimring, *Modifying Trusts; Fixing Problems*, Stetson University College of Law Special Needs Trusts VIII - The National Conference, 2006.

[29]Restatement of Trust 3d, §63(1).

interpretation."[30]

b. The Restatement further provides that the trust itself may grant the trustee, beneficiaries or third parties powers regarding modification or revocation.[31]

c. Under the Restatement, irrevocable trusts can be modified or terminated by the consent of all the beneficiaries unless such termination or modification would be inconsistent with a material purpose of the trust, in which case the consent of the settlor is required or, if the settlor is deceased, a court determines that the reason(s) for the modification or termination outweigh the material purpose.[32]

d. Finally, the Restatement holds that a court may modify administrative or distributive provisions of the trust if circumstances not anticipated by the settlor require such modification to further the purposes of the trust.[33] In fact, the Restatement goes so far as to state that it is the duty of a trustee to seek such relief in circumstances where to fail to do so could cause substantial harm to the trust or its

[30]Restatement of Trusts 3d, §63(2).

[31]Restatement of Trusts 3d, §64.

[32]Restatement of Trusts 3d, §65.

[33]Restatement of Trusts, 3d. §66(1).

beneficiaries.[34]

C. Modification By The Trustee

1. By far, one of the most common provisions authorizing modification vests that power in the trustee. For example:

> "The Trustee may, in the Trustee's sole and absolute discretion, amend this Trust to conform with subsequent changes in federal or state law or regulations established thereunder in order to better effect the purposes of the Trust. The Trustee shall disclose any Trust amendment with the next annual accounting. Further, the Trustee may petition to a court with jurisdiction over the Trust, or to a court where the Beneficiary lives, or where the Trust has property, for authority to amend the trust to better effect the purposes of the Trust."[35]

A more comprehensive clause:

> "This trust is irrevocable and unamendable; provided however, that in the event that any provision of this trust fails to meet the financial eligibility requirements of any program of means-tested public benefits for which the beneficiary is or may be eligible, the then-acting trustee or trustees may, in his, her or their discretion, amend the trust to ensure eligibility for such benefits. Any such amendment shall be in a writing dated and signed by the trustee or trustees and duly-acknowledged. In no event shall said trustee have any power or authority under this Article which shall constitute a general power of appointment under Internal Revenue Code section 2041 and applicable regulations.

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[34]Restatement of Trusts, 3d. §66(2).

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

> In addition, nothing herein shall be construed as depriving any person of the right to seek modification or reformation of this under California Probate Code sections 15400-15414, or other California Probate Code sections then in effect that govern such trusts. In no event shall the beneficiary have any right or power to alter, amend, revoke or terminate the Trust, or any of the terms of the Trust instrument, in whole or in part. Furthermore, the beneficiary shall have no right, power or legal authority to direct the use of the trust corpus for the beneficiary's own support and maintenance."[36]

2. There is nothing wrong in granting this power to the trustee so long as the Settlor and drafting attorney are confident in the identity and ability of the trustee or successor trustee to act in an appropriate manner. If the various named trustees are all either professionals or persons or entities independent and neutral to the beneficiary, this is probably not a problem. On the other hand, if the trustee (or any of them) is a person who may, potentially, be adverse to the beneficiary, problems can arise.

3. For example, if the trustee (or a successor trustee) is a sibling of the beneficiary and therefore, presumably a remainder beneficiary, such a person could easily be put in an adversarial posture to the beneficiary. (This problem would as easily occur in connection with discretionary distributions, but this paper will not deal with that issue or the more critical issue of whether or not it is appropriate to appoint a potentially adverse party as trustee in

[36]Sterling L. Ross, Jr. ,*Special Needs Trusts*, in *Drafting California Irrevocable Trusts, 3d Edition*, 619, 660 (John R. Cohan, editor, Continuing Education of the Bar - California 2004).

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

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

> "A trust, as the term is used in this Restatement when not qualified by the word 'resulting' or 'constructive,' is a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee." [emphasis added] [37]

Comment "b" to Restatement §2 goes on to state:

> "Despite the differences in the legal circumstances and responsibilities of various fiduciaries, one characteristic is common to all: a person in a fiduciary relationship to another is under a duty to act for the benefit of the other as to matters within the scope of the relationship."[38]

5. Thus, whether or not the trust document specifically sets forth language regarding the trustee's duty *vis a vis* the beneficiary, it can (and

[37]Restatement 3d, §2.

[38]Restatement 3d, §2, Comment b.

should) be argued that the trustee, simply by virtue of his or her office, has a duty to the beneficiary to act in an appropriate manner. However, in the context of this discussion, if the trustee is the holder of the authority to modify the trust and elects not to do so for personal gain, who will act to protect the beneficiary's interest if the beneficiary is unable to do so?

D. Modification By A Third Party

1. It is with that question in mind, *i.e.* "Who will protect the beneficiary if the trustee does not, or turns out to be adverse to the beneficiary,?" that some drafters utilize the office of a "trust protector" or "special trustee," either individually or as a member of a committee.

2. Commonly, a trust advisory committee, a trust protector or a special trustee (hereafter simply referred to as a "trust protector") fulfills a number of roles. The trust protector may advise the trustee on specific needs of the beneficiary. The trust protector may have authority to direct the trustee to make specific types of distributions for the benefit of the trustee. In appropriate circumstances (especially when there is only one trust protector rather than a committee), it may be appropriate to vest the modification power in the trust protector rather than the trustee.

3. As noted above, vesting the power in the trust protector rather than in the trustee is particularly appropriate where the trustee (or a successor trustee) may, in certain circumstances, have a potentially adverse

relationship to the beneficiary. In such cases, the trust can provide that where such a conflict arises, any powers held by the trustee automatically default to the trust protector. Alternatively, to avoid any question as to when such powers are granted to the trust protector, the document can specifically set forth the powers that vest in the trust protector.

A sample of the first kind of clause is:

> ~___, ~___ and ~___ are appointed the initial members of the Trust Advisory Committee. There shall always be an odd number of members of the Trust Advisory Committee, with a minimum number of ~___. All actions of the Trust Advisory Committee shall be by unanimous vote of the members of the Trust Advisory Committee acting from time to time. Any member of the Trust Advisory Committee shall have the right to resign at any time. The members of the Trust Advisory Committee, from time to time, may appoint new members of the Trust Advisory Committee to act along with the members then acting, or to act as successors to them. Also, the members of the Trust Advisory Committee, from time to time, may remove a member of the Trust Advisory Committee with the approval of the court having jurisdiction over the Trust. Any such appointment or removal shall be in writing and shall be filed with the records of the Trust. No bond shall be required of any person acting as a member of the Trust Advisory Committee.
>
> The Trust Advisory Committee shall have the power and authority, in its discretion, to determine and direct the Trustee concerning payments to be made to or for the benefit of the Beneficiary during his/her lifetime. Notwithstanding any provisions of this instrument to the contrary, payments by the Trustee to or for the benefit of the Beneficiary shall be made only

> upon direction of the Trust Advisory Committee. In all respects other than the discretion granted to the Trust Advisory Committee to direct payments to or for the benefit of the Beneficiary, the Trustee shall have all the rights, titles, interests, powers, duties, and discretions in connection with the administration and management of the Trust.

The second kind of clause would simply substitute the trust protector for the trustee.

E. Scope of Authority to Modify

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

2. The clauses set forth above give the trustee the authority to modify the trust under certain, specified circumstances. The underlying rationale of the grant of authority is set forth to both guide the trustee and any judicial interpreter of the instrument.

3. On the other hand, there may well be situations where a broader grant of authority would be appropriate. For example, if a SNT is being established for a young child whose ultimate prognosis is unknown, but at the time the trust is being established is greatly in need of various services public benefit agencies can supply, the drafter may want to authorize the trustee to liberalize the distribution provisions to take into account improvements in the

beneficiary's condition or advances in medical or other therapies. In such cases, the drafter should exercise caution so as not to create too much flexibility which might lead to an attack on the trust as being "available" to the beneficiary by virtue of the trustee's authority.

4. Further, where the trustee is a remainder beneficiary, care should be exercised in not granting so much authority to the trustee to modify the trust that it can be argued that there has been a merger[39] or the creation of a general power of appointment which would subject the trust corpus to taxation in the trustee/remainder beneficiary's estate.[40] In reality, this particular problem is more likely to occur in termination situations discussed below, than in modification situations.

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

F. Statutory Modification Requiring Court Action

Where the trust is silent on the subject of modification, statutes frequently offer relief, following the Restatement position. For example, California law provides:

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

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

> "a) Except as provided in subdivision (b), if all beneficiaries of an irrevocable trust consent, they may compel modification or termination of the trust upon petition to the court.
>
> (b) If the continuance of the trust is necessary to carry out a material purpose of the trust, the trust cannot be modified or terminated unless the court, in its discretion, determines that the reason for doing so under the circumstances outweighs the interest in accomplishing a material purpose of the trust. Under this section the court does not have discretion to permit termination of a trust that is subject to a valid restraint on transfer of the beneficiary's interest as provided in Chapter 2 (commencing with Section 15300)."[41]

G. Modification By Statute Without Court Action

1. On the other hand, where the beneficiaries and/or the settlor of the trust are still alive, some state statutes provide a non-judicial method of modification where all parties concur.

2. For example, California law provides:

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

[41]California Probate Code §15403.

> (c) If the trust provides for the disposition of principal to a class of persons described only as "heirs" or "next of kin" of the settlor, or using other words that describe the class of all persons who would take under the rules of intestacy, the court may limit the class of beneficiaries whose consent is needed to compel the modification or termination of the trust to the beneficiaries who are reasonably likely to take under the circumstances.[42]

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

[42]California Probate Code§15404.

permits the trustee and all beneficiaries to "...Direct or permit the trustee to do acts that are not authorized or that are prohibited by the terms of the trust....,"[43] it gives one pause.[44]

H. Judicial Reformation of SNT

1. It is one thing for a statute to permit reformation and another for a court to actually do it. As noted above, when judicial modification is authorized, the court is required to determine the intent of the settlor and then decide whether or not there have been changed circumstances, frustration of purpose, impossibility of performance or some other, extrinsic event that justifies modification or reformation.[45]

2. If the settlor had no knowledge of the beneficiary's disability, the issue of proof is rather simple: can it be established that if the settlor had known of the condition, she would have created a SNT rather than the type of trust that was created? If the answer is "yes," then the petition to modify will probably be granted. It is "simply" a question of establishing the settlor's intent. As an example, many California planners used language similar to this as part of their "standard" language:

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[43]Florida Stats §737.4032(c).

[44]For an excellent discussion of Florida-specific issues regarding trust modification, see Mary Alice Jackson, CELA *"Fixing Problems: Florida Specific Issues"* in Stetson University College of Law *"Special Needs Trust V,"* October, 2003.

[45]See, for example, Florida Statutes §737.4031 and California Probate Code §15403(b).

> "If any person entitled to outright distribution of a portion of the Trust is under age twenty-one (21), or if the Trustee shall determine that there is a compelling reason (such as a serious disability, a pending divorce, potential financial difficulty, a serious tax disadvantage in making the distribution, or a similar substantial cause) to postpone a distribution in complete or partial termination of the Trust, the Trustee shall continue to hold and administer that beneficiary's share for his or her benefit."

Using this language, the author has successfully argued on a number of occasions that the settlor had a clear, manifest intent to protect beneficiaries who suffered from any disability.

3. A more difficult fact situation is presented when the Settlor knew of the individual's disability and failed to provide for it in the trust. In these cases, one can argue that the Settlor did not understand that the trust, as drafted, would render the beneficiary ineligible for public benefits. While it is difficult to generalize, and there are few reported cases, it seems that the position taken in a 2007 New York case, embodies the most rational, commonsense approach.

In that case, the settlor died leaving a share of his estate in a support trust for the benefit of one of his sons who had a disability. The Guardian ad litem for the son petitioned the court to reform the trust from a support trust to a SNT. The drafting attorney submitted an affidavit stating that the trust was drafted when the settlor was terminally ill, and that there was insufficient time to consider a SNT. The affidavit further stated that had the settlor properly considered his son's condition and the impact the trust would have

on his public benefits, he would have instructed the draftsperson to create a SNT.

Based on this, the court held that there was a presumptive intent on the part of the Settlor to take advantage of all available public benefits, similar to the presumption that a settlor/testator will want to reduce her tax exposure to the greatest extent possible. Citing the Restatement of the Law of Property Third, the court held: "...a donative document, though unambiguous, may be reformed to conform the text to the donor's intention, if it is established by clear and convincing evidence that a mistake of fact or law affected the terms of the document and what the donor's intention was."[46]

4. Obviously, these cases are very fact specific. Further, because they rely so heavily on judicial discretion, it is extremely difficult to predict the outcome from jurisdiction to jurisdiction.

I. Judicial Interpretation of Trustee Discretion

1. A related issue is that of judicial "second guessing" of the discretionary decisions made by trustees. The issue is coming up more frequently in the area of SNTs because some state Medicaid agencies are becoming more aggressive. They are demanding that trustees exercise their discretion to make distributions and taking the trustee to court when she does not.

[46]Matter of Longhine, 2007 N.Y. Slip Op. 50517 (U) (Feb. 27, 2007), unpublished. Cited in Thomas D. Begley Jr., Angela E. Canellos Special Needs Trust Handbook 2008 (Aspen Publishers).

2. Here, the issue is becoming as much political as it is legal. State Medicaid agencies are taking the position that it is against public policy to permit a trustee not to make a distribution if the exercise of that discretion results in the trust's beneficiary becoming eligible for public benefits. The cases are literally all over the map.

3. This argument was advanced by the Ohio State Medicaid Agency in attacking a third party SNT. The Trust was upheld on a four-to-three decision over a strong dissent arguing that the SNT violated public policy by shifting "the beneficiary's financial responsibility to the taxpayers despite the fact [that] the beneficiary has the financial means to pay for his or her own medical expenses."[47]

4. On the other hand, a California case held that where the trust gave the trustee full discretion to use income and principal for the benefit of the beneficiary (the settlor's sister) and specifically directed the trustee to take into account that the settlor had, prior to his death, paid $25 per month for the beneficiary's support, the trustee did not abuse his discretion in continuing to pay only $25 per month in order to preserve the beneficiary's public benefits.[48]

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[47]Young v. State Dept. of Human Svcs., 76 Ohio State 3d 547, 668 N.E. 2d. 908 (Ohio 1996).

[48]Estate of Johnson, 198 Cal. App. 2d 503, 17 Cal. Rptr. 909 (1961). See also, Dept. of Public Welfare v. Meek, 264 Ky. 771, 95 S.W.2d 599 (1936) for a similar result.

7. **Termination**

A. Generally

Generally speaking, a trust terminates upon the expiration of a period of time, the happening of a specific event as provided in the trust, or the exhaustion of the trust's assets. In the absence of specific provisions governing termination, termination will occur when the trust's purpose is accomplished.[49]

B. On Death of Primary Beneficiary Or On Full Distribution of Assets

1. The most common reasons that a trust (whether a SNT or other kind) terminates is the death of the primary beneficiary or the exhaustion of the trust's assets. Thus, in First Party SNTs the most commonly seen provision usually reads as follows:

> "This trust shall terminate upon the death of the Beneficiary. In accordance with 42 U.S.C.§1396p(d) (4) (A), upon termination, and after payment or provision has been made for expenses of administration and other obligations payable by the Trust, the remaining Trust Estate shall be payable to any state, or agency of a state, which has provided medical assistance to the Beneficiary under a state plan under Title XIX of the Social Security Act, up to an amount equal to the total medical assistance paid on behalf of the Beneficiary under such state plan.
>
> After such payment or payments have been made, the remaining Trust Estate shall be

[49]Restatement of Trusts 3d, §61.

distributed to the person or persons, excluding the Beneficiary, creditors of the Beneficiary, the Estate of the Beneficiary, or creditors of the Estate of the Beneficiary, in such manner and proportions as shall be designated by the Beneficiary by written instrument delivered to the Trustee or by specific reference to this power by the Beneficiary's last Will. Any prospective appointment may be revoked by a subsequent written instrument delivered to the Trustee or by specific reference to the revocation by the Beneficiary's last Will. If the exercise of any of said powers of appointment is inconsistent with any other exercise of said powers, the provisions of the instrument bearing the later date shall prevail. To the extent any or all of the remaining Trust Estate is not appointed because of the nonexercise or invalid exercise of such power, said remaining Trust Estate shall be distributed to JOHN DOE, if he survives the Beneficiary by a period of thirty (30) days. If JOHN DOE fails to survive the Beneficiary by a period of thirty (30) days, the gift to him shall lapse and shall pass to the legal heirs of the Beneficiary. The identity of said heirs shall be determined according to the laws of succession of the State of California then in force relating to the succession of separate property not received from the separate property of a predeceased spouse. The determination of the identity and respective shares of such legal heirs shall be made by the Trustee, in the Trustee's sole judgment and discretion, and shall be conclusive upon all such heirs and other persons interested in this Trust, and the Trustee shall not be liable for any errors or omissions in making such determination."

2. In a "(d)(4)(A)" SNT, this will trigger the "payback provisions" required by law,[50] with the remaining balance of corpus, if any, being distributed in

[50]42 U.S.C.§1396p(d) (4) (A)

accordance with the trust's terms. Because the governing statutes and regulations set out the hierarchy of entitlement to reimbursement, the drafter should carefully craft these provisions to avoid conflicts between the statute, the trust and potential claims by either the state agency or the remainder beneficiaries.

3. It should be noted that there are exceptions to the reimbursement requirements of 42 U.S.C. 1396p(d)(4)(A). In California, for example, if the remainder beneficiary of a first party SNT is herself a disabled individual, Medi-Cal is not entitled to reimbursement.[51]

4. In a third-party SNT, the corpus remaining on the death of the primary beneficiary can be distributed in any manner the settlor desires. In such cases, the drafting considerations dealing with distributions to remainder persons are no different than any other trust.

C. On Failure of Purpose

1. Usually, but not always, the purpose of the SNT, *i.e.*, to render the corpus as an "unavailable resource" for public benefits purposes, is not going to change over time. However, there are at least two situations where the purpose may cease to be relevant:

a. If the need for public benefits ceases to exist because the

[51] *Shewry v Arnold*, 125 Cal. App. 4th 186, 22 Cal. Rptr. 3d 488 ((2nd App.Dist. 2005), Cal. W&I Code §14009.5(b)(2)(C).

beneficiary no longer requires public benefits; or

b. The public benefits themselves no longer exist.

2. As families become more and more familiar with the concept of SNTs, we are seeing an increase in advance planning for younger beneficiaries whose long-term prognoses are often unknown. The easiest example is a young autistic child. Today, his or her condition may be severe, but as more is understood about the condition, more and better treatment options will become available, setting the stage for the child to function in a normal manner. Similarly, the child may well "outgrow" the condition, fully or partially, thus eliminating the need for public benefits. If the need for public benefits no longer exists, what should happen to the trust corpus?

3. In the author's opinion, if the discretionary distribution language has been properly drafted, the trustee will already have the requisite authority to deal with this situation. For example, if the distribution clause states:

> "The Trustee shall, in the Trustee's sole and absolute discretion, distribute so much income and principal to or for the benefit of the Beneficiary as the Trustee shall, in the Trustee's sole discretion, determine in order to provide supplemental benefits, as hereinafter defined, to the benefits receivable by the Beneficiary through or from various governmental assistance programs. The Trustee is prohibited from making any distribution to any governmental entity to replace or reimburse or supplant any public assistance benefit of any county, state, federal or other governmental agency which has a legal responsibility to serve persons similar to the Beneficiary herein, and shall not distribute Trust assets to or for the benefit of the

> Beneficiary for such needs as would be provided for in the absence of this Trust by governmental financial assistance and/or benefits and/or by any provider of services. In no event shall Trust property be distributed in such manner that any governmental financial assistance which would be available to the Beneficiary if this Trust did not exist, is in any way denied. All terms of this Trust, wherever they may appear, shall be interpreted to conform to this primary goal, namely that the governmental financial assistance which would otherwise be available to the Beneficiary if this Trust did not exist will in no way be denied. However, a distribution may be made by the Trustee, in the Trustee's sole discretion, in order to meet a need of the Beneficiary for supplemental benefits not otherwise met by governmental financial assistance."

the trustee has inherent authority to make distribution to or for the benefit of the Beneficiary without regard to public benefit restrictions since there are no longer any public benefits to restrict the distributions.

4. Similarly, the trustee could be authorized to terminate the trust under these circumstances and distribute the corpus out to the beneficiary. The author advises against including such language in a self-settled SNT since it would probably stand out as a glaring "red flag" to the various governmental agencies of the trustee's ability to terminate the Trust and make distribution directly to the beneficiary. In the case of the third-party trust this, of course, would not be a problem since the "pay back" rules do not apply.

5. Alternatively, especially in third-party trust situations, the trustee or other independent party could be given authority to terminate all or a portion

of the trust and have it pour over to another, more "liberal" trust, such as a "health/education/maintenance/support" type support trust, or a trust with mandatory distribution provisions. The author has drafted a number of such trusts where, if the clause is triggered, the corpus of the third-party SNT flows back to a "conventional" trust already created within the Settlor's primary estate planning trust.

6. The second situation is more unfortunate, but easier to deal with. If the frustration of the Trust's purpose occurs because the public benefits programs themselves disappear, the trustee's options would appear to be simple. There are no longer any programs for which the beneficiary qualifies and therefore, there are no longer any restrictions affecting the trustee's discretion to make distributions.

7. Other drafters are not as skittish as the author in authorizing termination under these circumstances. Richard Courtney of Jackson, Mississippi, has used the following language in self-settled trusts:

> "It is specifically acknowledged that the primary purpose of this trust is to preserve Medicaid and/or SSI benefit eligibility for the Beneficiary who is 'disabled' as defined in 42 U.S.C. §1382(a)(3) and who is otherwise eligible for such benefits. If the Trustee determines that Beneficiary no longer requires or is no longer eligible for public benefits, or such benefits are not in the best interests of the Beneficiary, the Trustee may seek court approval to terminate the Trust and distribute the Trust Estate in accordance with the direction of the court. The Mississippi Division of Medicaid shall be given advance written notice of any such action. Upon

> court approval of such termination, the Trustee shall give written notice to Beneficiary that Beneficiary has the right to terminate this Trust and withdraw assets by providing written notice of termination (in whole or as to specific assets) to the Trustee. In the event termination is sought only as to specific assets, and not the Trust in total, all assets to be included in the Beneficiary's written notice of termination shall remain in this Trust subject to its terms and conditions. The right to terminate and withdraw is personal to the Beneficiary and may be exercised only by Beneficiary, individually or through Beneficiary's guardian or conservator."

8. Katherine N. Barr of Birmingham, Alabama, takes what the author considers a less conservative but not necessarily more cautious approach since she vests the power of termination in the beneficiary, rather than in the Trustee or a third party:

> "If at any time after Beneficiary reaches her thirtieth (30th) birthday, she is not considered 'disabled' as defined within the meaning of 42 U.S.C. §1382(c)(1)(3) of the Social Security Act, she shall have the continuing right, as long as she is not so disabled, to give written notice to the Trustee of her desire, if any, to terminate this Trust and withdraw its assets, subject to the provisions of Paragraph X, above [the payback provisions] if an applicable State agency requires such a payback as set forth in such paragraph. This right to terminate and withdraw is personal to the Beneficiary and may be exercised only by her, and not by any agent or other person or legal representative of Beneficiary acting on her behalf."

D. On Threat of Inclusion of Trust Corpus As Resource

1. Drafters of SNTs frequently include clauses such as this:

> "Termination Because of Ineligibility: Notwithstanding anything to the contrary contained in the other provisions of this Trust, in the event that the Trustee's discretionary right to invade Trust principal for the Beneficiary herein has the effect of rendering the Beneficiary ineligible for Supplementary Security Income (SSI), Medi-Cal or subsidized housing, the Trustee is authorized to terminate this Trust, and the undistributed balance of the Trust Estate shall be distributed to the Beneficiaries in the same manner and upon the same terms set forth above in Paragraph 3.7 as if the Beneficiary were deceased.
>
> In determining whether the existence of the Trust has the effect of rendering said Beneficiary ineligible for SSI or Medi-Cal, the Trustee is hereby granted full and complete discretion to initiate either administrative or judicial proceedings, or both, for the purpose of determining eligibility, and all costs relating thereto, including reasonable attorney fees, shall be a proper charge to the Trust Estate."

2. The theory behind the use of such clauses is essentially to act as an *in terrorem* or "poison pill." If a state agency attempts to pierce through the trust and either obtain the assets or have them declared as an "available resource," the trustee can simply point to this clause and say "fine - take your best shot, but if you do, I'm going to terminate the trust and distribute the assets to the remainder beneficiaries."

3. The problem with this theory is that it may (probably does) not work in connection with self-settled trusts. Drafters of self-settled SNTs must keep in mind that the trusts they draft are not creditor protection devices; they are

grantor trusts and therefore, except in those states that permit self-settled asset protection trusts, the assets of the trust will be exposed to the debts of the settlor/beneficiary.[52]

4. Likewise, if it is determined that the trust corpus is an "available resource," transferring that resource is not necessarily going to help the beneficiary. It may even harm the beneficiary by creating up to a sixty (60) month period of disqualification because of the transfer.[53] Further, an argument could be made that the remainder beneficiary holds the distributed assets as a constructive trustee for the benefit of the primary beneficiary or (worse) for the state agency.[54]

E. The Ultimate Modification Solution

1. ACTEC Fellow Alan S. Acker, in an article entitled "Fixing Broken Irrevocable Trusts," posits a fascinating suggestion: "Do what you want to do anyway." Mr. Acker cites Section 1009 of the Uniform Trust Code which provides, *inter alia*, that a trustee is not liable to a beneficiary for breach of trust if in fact the beneficiary consented to the trustee's conduct that constituted the breach, ratified the transaction which constitutes the breach, or released the trustee from liability, unless the consent, release or

[52]See Robert F. Collins, Esq. L.L.M. "The Greater Asset Protection Self Settled Special Needs Trust (GAPSNT), 2004 NAELA Symposium.

[53]42 U.S.C. §1396p(d)

[54]31 ACTEC Journal 230 (2005)

ratification by the beneficiary was induced by improper conduct of the trustee or if at the time of the consent, release or ratification, the beneficiary did not know of the beneficiary's rights or of the material facts relating to the breach.

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

3. While the author commends Mr. Acker on his creativity and his gutsy approach, one has to ask oneself the question of whether or not he or she would be willing to put his or her client, as Trustee, in the position of making a distribution under these circumstances, regardless of how "ironclad" one felt the release was framed. That said, it is certainly something worth thinking about when all else fails.

8. Conclusion

We cannot cure the diseases or conditions that afflict those with disabilities. However, astute and informed drafting of SNTs can aid families and friends in providing resources and financial assistance in meaningful ways for these individuals. In so doing we not only assist our clients but the people they care about as well. What could be better?