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PERSPECTIVE

Special needs trusts require key choices

By William L. Winslow

When an injured party settles a suit for personal injury damages or a claim for workers' compensation benefits and needs to have a special needs trust, or SNT, established to receive the settlement proceeds, key planning decisions involving *choice of a trustee and funding* of the trust are required.

An SNT is needed where the injury victim has to become or remain eligible for certain means-tested government assistance programs. In general, to be eligible a disabled or elderly individual may have no more than \$2,000 in available resources and there are strict limits on monthly income. Receipt of any substantial settlement will cause a loss of benefits until the settlement is spent down below \$2,000 unless the settlement goes into an SNT. If an SNT is properly established and administered, its assets will be exempt from the resources count, and its income also will not be counted for the purposes of determining eligibility.

Most often, the SNT will be one meeting the safe harbor requirements of 42 U.S.C. Section 1396p(d)(4)(A). The resources and income count will *not* include assets and income of a trust established for a disabled individual under age 65 by a parent, grandparent, legal guardian or court, if the state's Medicaid program (e.g., Medi-Cal) will be reimbursed from trust assets, to the extent of its outlays, on the death of such individual. Such a "first-party" SNT cannot be established by the disabled person, who is also not able to serve as trustee; it cannot be revocable by the trust beneficiary; and it must contain a provision that upon termination of the trust, any outlays by a Medicaid program will be repaid to the extent of the remaining trust assets.

The SNT can be funded by all cash only, all structured settlement payments, or a combination of both. Deciding the right mix is intertwined with the type of trustee selected. There are three main options: (1) a trusted family member or friend, (2) a bank or (3) a private professional fiduciary. When the beneficiary is over 65, a "pooled" SNT under Section 1396p(d)(4)(A), with a nonprofit serving as trustee, is the only choice available.

Size affects choices

The amount available for funding the trust is the starting point for choosing a suitable trustee. For example, bank trustees will not accept smaller trusts. Size

will also influence the funding mix. If the funding available is near the minimum for a bank trustee, then a settlement that devotes much of the net settlement proceeds to a structured annuity may cause the bank trustee to decline to serve.

Family members or friends

Often the impulse to keep control of money within the family is strong. Even where an honest, capable relative is available to serve, that person may not be the best choice. Rarely do relatives have any experience with trusts or long-term income production. It would be incorrect,

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however, to say that one can never find a member of a family to do a good job.

Rule 7.903 of the California Rules of Court requires that any natural person serving as trustee of a court-supervised trust be bonded. In essence, an insurer that issues the trustee's bond guarantees that, in the event of loss of trust assets due to misconduct or neglect of the trustee, the loss will be made good by the insurer. The premiums on the bond are paid from trust assets. Typically, cost is about 6 percent of the value of trust assets plus 12 months of income *in the hands of the trustee*.

To qualify for a bond, the prospective trustee must be vetted (e.g., credit history, employment record, convictions, etc.). Many low income families do not have a person who qualifies. The solution may be to put part of the money into a blocked account so that a smaller bond is needed. The use of a structured settlement — meaning regular annuity payments — will result in a lower bond requirement. Of course, a candidate may have to apply and be turned down before other alternatives will get serious consideration.

A caveat: Anytime a layperson will serve as trustee, it is worth considering whether he or she can stand up to pressure for improvident spending. A common problem encountered by trustees of SNTs is the tendency of the beneficiary or relatives to resist making and keeping to a budget.

Banks

Usually the trust department of a bank can be counted upon to know and perform its duties under the trust instrument and

applicable law, especially if it has some experience with SNTs. Bank trustees do not post bond, as their fidelity is upheld through regulations. Assets are safe; even if the bank becomes insolvent, its trust operation's assets could not be reached by creditors.

Banks charge hefty trustee's fees — a fee of 1.5 percent of the first \$1 million in assets, sliding down thereafter, is typical. However, fees are generally justified by performance in the highly important sphere of investment of trust assets.

Bank trustees will tend to discourage any great reliance on structured settlement funding because they believe that their investing accomplishes better results. However, the income-tax-free character of structured payments may produce a lower income tax bill.

Bank trustees occasionally fall down on the "social services" side of being trustee for disabled persons. A bank that is good at money management but neglects to provide thoughtful, engaged case management services is unsatisfactory.

Private professional fiduciaries

There are now in California several hundred individuals, called private professional fiduciaries, who make a profession of serving as conservators, guardians and trustees of court-supervised and non-supervised trusts. All private professional fiduciaries must be licensed by the Professional Fiduciaries Bureau (Cal. Bus. & Prof. Code Section 6530 et seq.). The bureau sets standards for fiduciaries and maintains a database.

Where the amount available to fund the trust is substantial but below the threshold required by a bank, and no trusted layperson is available, a private professional fiduciary is the best alternative. Most of the SNTs using these professionals have funding in the \$125,000 to \$1,000,000 range.

Private fiduciary fees are generally much lower than banks, but they are not fulltime investment professionals. Where a private fiduciary attempts to meet the challenges of investing by hiring a professional investment advisor, the advisor's fees will often be in the neighborhood of 1 percent of the value of the trust assets. This makes the overall fee for the trusteeship not much less than what a bank charges. Yet professional fiduciaries will not undertake foolhardy investments and often provide quite good, cost-effective services.

Many lawyers for disabled individuals

who have a strong commitment to the use of structured settlements, especially for the conservative side of the client's financial future, will fund an SNT by allocating 40 to 60 percent of the net settlement proceeds to annuity funding and the balance to upfront cash, to be invested in, e.g., mutual funds that hold blue-chip stocks. This combination will provide the private professional fiduciary with guaranteed receipts to budget with, balanced by investments that can grow and combat inflation.

The pooled special needs trust

There is one other SNT option that is not underpinned by Section 1396p(d)(4)(A), but instead relies on another safe harbor at Section 1396p(d)(4)(C). It is called a "pooled" SNT because the trust is established by a nonprofit association, a separate account is maintained for each beneficiary, and the assets of all the accounts are *pooled* for purposes of investment.

A big attraction of pooled trusts is that there is no age restriction — unlike trusts established under Section 1396p(d)(4)(A), which are limited to persons under 65. Also, the disabled individual can create an account in this type of trust; no court order is required. This saves expense initially, and the absence of court supervision reduces the cost of administration substantially. The low overhead is another attractive feature with smaller SNTs. On the other hand, with no judge watching its affairs, the reliability of the trustee of a pooled trust requires careful inquiry by counsel. However, a pooled trustee may be willing to file court accountings.

William L. Winslow is a partner with Farmer & Ridley LLP. He can be reached at wwinslow@f-rlaw.com. Caption



WILLIAM WINSLOW
Farmer & Ridley LLP