

**SACRAMENTO CHAPTER
OF THE
SOCIETY OF CALIFORNIA ACCOUNTS**

PRESENTS

SPECIAL NEEDS TRUSTS

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SPECIAL NEEDS TRUSTS

I. PLANNING FOR SPECIAL NEEDS TRUSTS (“SNTs”)

A. Purpose of SNTs

The main purpose for creating an SNT is to preserve public benefits for disabled and/or aged beneficiaries. Generally, public benefits that are “asset sensitive” are relevant to the planning of an SNT. There are a number of reasons for creating an effective SNT, some of which include:

- The statutes and regulations relating to public benefits law are difficult to find and extremely complex;
- It is difficult to acquire authoritative advice on the subject matter; and
- SNT law may change during the term of the SNT (as it has in the past).

B. Public Benefits: SSI and Medi-Cal

1. Overview

The main public benefits available to the disabled and aged populations are Supplemental Security Income (“SSI”) and Medi-Cal (the California state incarnation of Medicaid). SSI provides cash benefits to blind, disabled, and persons 65 years of age or older. Medi-Cal provides payment for a number of medical treatments as well as long-term nursing home care.

Both programs are need based. A person who is eligible for SSI benefits is also eligible for Medi-Cal. However, a person who is not eligible for SSI benefits is only eligible for Medi-Cal benefits if there are “medically needy.”

Any benefits a person receives from SSI or Medi-Cal when the person is not eligible for benefits must be repaid to the state. SSI is administered by the Social Security Administration, although basic grants are supplemented by the state. Medi-Cal is state administered and funded by both state and federal monies. As a result, SNT planners should consult both state and federal regulations and statutes. Additional guidelines are provided by the following federal and state agencies:

- The Social Security Administration’s Program Operations Manual System (“POMS”) covers SSI
- The California Department of Health Care Services (“DHCS”) All-County Welfare Directors (“ACWD”) Letters govern Medi-Cal. The California guidelines of the federal Centers for Medicare & Medicaid Services (“CMS”) also govern Medi-Cal.

2. SSI Benefits

SSI provides monthly payments to supplement income to a regulatory maximum. The benefits, which are annually adjusted, are provided in the Federal Register every February, effective April 1 of that year.

a. Eligibility

There are two basic requirements for qualifying for SSI benefits:

- The applicant must be disabled, blind, or 65 years of age or older
- The applicant must not have more than the permissible income and resources needed to pay for food and shelter.

Any additional income and resources causes a reduction in the SSI monthly stipend.

b. Limitations

A person who is otherwise eligible for SSI benefits loses eligibility if the applicant's resources exceed \$2,000, if single, and \$3,000, if married. A number of items are specifically excluded from determining an applicant's "resources," including:

- i. The applicant's personal residence, regardless of value.
- ii. Furniture, clothing, and other personal care items to the extent their value is a "reasonable amount."
- iii. An automobile used for transportation regardless of value.
- iv. Certain burial spaces, and certain types of life insurance contracts are also excluded, as are current other assets.

c. Effects of Income

Under SSI regulations, income is either earned or unearned. Both forms of income reduce SSI benefits dollar for dollar. Unearned income includes gifts, inheritances, and additions to trusts. However, **not all income is counted**. Small **first portions of unearned and earned income are excluded** for policy reasons.

Provision of "in-kind support and maintenance" ("ISM") also reduces SSI benefits. ISM is food or shelter provided directly to the recipient or paid for by a third party. However, the reduction is not the same as cash income. Instead of reducing dollar for dollar, there is a maximum reduction limit. The maximum reduction is governed by the presumed maximum value rule ("PMV"). Under the PMV rule, ISM is valued at either its actual value or one-third of the federal benefit portion (plus a \$20 general income exclusion), whichever is less.

d. Transfer Rules

The SSI transfer rules are designed to disqualify individuals who make gifts of their assets or otherwise dispose of them at “less the fair-market value” for the purposes of qualifying for SSI benefits. If a person violates the transfer rules, that person become ineligible for SSI benefits for up to 36 months, depending on the value of the gift or transfer. It should be noted that SSI transfer rules only apply to resources and NOT income.

3. Medi-Cal Benefits

Medi-Cal provides benefits in the form of payment for hospitalization, treatment in medical clinics, doctor services, lab tests, X-rays, home and nursing home care, and a variety of other medical services (including mental health and drug abuse services).

a. Eligibility

There are two categories of individuals eligible for Medi-Cal benefits. First, with certain limited exceptions, an individual who receives SSI automatically qualifies for Medi-Cal (“categorically needy”). Second, a person whose income level is above SSI eligibility levels may still be eligible for Medi-Cal if medical expenses would reduce that person’s income below a “maintenance need” level (“medically needy”).

For medically needy individuals, the income over the maintenance need level (the percentage of the SSI cash grant payable to a person with no income or resources) is applied to payment of medical services as the medically needy person’s “share of cost.”

b. Transfer Rules

To prevent disposal of assets for less than FMV for the purposes of qualifying for Medi-Cal, the transfer rules of Medi-Cal are for the same purpose as SSI transfer rules. The current ineligibility requirements disqualify an individual who violates the transfer rules for 30 to 60 months.

Medi-Cal considers both income and resources for the purposes of its transfer rules. As a result, the Medi-Cal transfer rules have become exceedingly complex as to what is included and excluded for transfer and valuation purposes. Additionally, there is a potential criminal penalty for counseling a person to dispose of assets to qualify for Medicaid.¹ Hence, anyone dealing with Medicaid and Medi-Cal planning should keep current as to the regulations regarding transfers of assets.

¹ A New York federal district court enjoined the provision.

c. Recovery Rules

There are Medi-Cal recovery rules that may apply depending on the circumstances under which benefits were received. These recovery rules categorize different circumstances in mandatory, permissive, and prohibited recoveries.

i. Mandatory Recovery. There is a mandatory recovery rule for individuals who are institutionalized (regardless of age). There is also mandatory recovery from the estate of a person received medical assistance for nursing facility services, or home and community based services when 55 years of age or older.

ii. Permissive Recovery. California has also chose to implement a permissive recovery rule for individuals 55 years of age or older for items under the state plan.

iii. Prohibited Recovery. Recovery is prohibited against the estates of persons who were under the age of 55 when the services were received and who were not residing in a “nursing facility, intermediate care facility for the mentally retarded, or other medical institution.”

For recovery purposes, the DHCS must claim against the estate of a deceased beneficiary and against any recipient of the property of that beneficiary an amount equal to the payment for the health care services or Medi-Cal benefits received that are subject to recovery. There are a number of exceptions for surviving spouses and children of beneficiaries who are under the age of 21 or blind or permanently and totally disabled.

iv. *[List exceptions? Or is the last sentence the list?]*

II. TYPES OF SPECIAL NEEDS TRUSTS

Under the Omnibus Budget Reconciliation Act of 1993 (“OBRA ’93”), a number of forms of SNTs were codified. The law creates different types of SNTs that apply to different situations. An SNT can be a testamentary trust or an inter vivos trust. It can be created by the beneficiary or by a third party. It may contain the assets of the beneficiary or be funded by a third party. The particular circumstances surrounding the creation and funding of the trust determine that type of trust used, and what requirements, statutory or otherwise, must be met. The three main types of SNTs are (i) third party SNTs; (ii) first party SNTs created as a **d4A** disability trust; and (iii) first party trusts created as a **d4C** or pooled trust.

A. Third Party SNTs

A third party SNT is one that is created by a donor who wants to set money aside, or bequeath a gift in a will or trust, without disrupting the beneficiary's eligibility for public benefits. In general, the donor is not trying to establish public benefits eligibility for the beneficiary, but only to ensure that the beneficiary will not be disqualified from current/future public benefits because of inheritance. There are two kinds of third-party SNTs that are in use in California:

- A testamentary trust is commonly used by parents/grandparents, who provide in their wills for distribution to the trustee of a SNT of the portion of their estate intended for their disabled child/ (though it can be set up and funded by any individual who makes the beneficiary their heir).
- An inter vivos trust is commonly used to receive gifts from several donors. For example, parents may establish an inter vivos SNT for a disabled child and then notify the grandparents of its existence. If the grandparents wish to leave assets to the disabled person, the inter vivos SNT can be used to consolidate asset management in a single entity, preserve public benefits, and alleviate the need for the grandparents to establish a testamentary SNT in their wills.

1. SSI SNT Rules

There are no statutory requirements for a third party SNT under Federal law. However, there are guidelines. A third party SNT need not be irrevocable to preserve public benefits. As long as the trust is not revocable by the public benefits beneficiary and that beneficiary cannot direct the use of the trust assets for support and maintenance, the trust assets should not constitute countable resources for SSI eligibility purposes. The reason the SNT need not be irrevocable by any other party besides the beneficiary is that allows the trustee to amend the SNT if the law changes. Additionally, California state law requires that the trust not mandate or permit disbursements for support and maintenance.

2. Medi-Cal Trust Regulations

Third party SNTs are included under a catchall definition as “trusts that are not described in Section 50489.1 or Section 50489.5” (under 22 Cal Code Regs § 50489.9(a)(1)). Under California regulations, a third party SNT need only meet this requirement as well as be irrevocable by the beneficiary. Though there is no separate requirement that the beneficiary not be able to direct the use of the funds, it is advisable for the purposes of SSI benefits to draft the SNT prohibiting such activity.

3. Income Taxation

A third party SNT is usually a complex trust, but a properly designed third party SNT may be treated as a grantor trust. If the trust is a grantor trust, all income will be taxed directly to the settler. Grantor trust treatment may be advantageous because the settler's payment of the taxes on trust income prevents depletion of the trust and payment of the tax is not treated as a taxable gift to the beneficiary (who would otherwise have to pay the tax). Grantor trust treatment also may allow the settler or the beneficiary to deduct medical expenses that would be nondeductible by the trust.

If the trust is not treated as a grantor trust, all income will be taxed to the trust subject to a distribution deduction for payments made to or for the benefit of the beneficiary, which distributions will be taxed to the beneficiary.

B. First Party SNTs

A **d4A** disability trust is also known as a first party SNT because it is established by an individual through another for his/her own benefit and using his/her own money to fund the trust. Traditionally, trusts were considered assets when created by the beneficiary. However, under OBRA '93, there is now a safe haven under **d4A** for first party trusts that meet certain statutory requirements. These requirements are:

- The trust is funded with the assets of the individual with a disability.
- The trust is established for the sole benefit of the individual with a disability.
- The individual is disabled as defined in 42 USC § 1382c(a)(3).
- The SNT is established by a parent, grandparent, legal guardian, or court. The person with the disability may establish his/her own SNT under **d4A**.
- The trust must include a payback provision that will reimburse Medi-Cal up to the amount of any costs paid on behalf of the disabled individual from the principal and accumulated interest remaining in trust at the beneficiary's death.
- Statutory liens must be paid before the trust is funded.

Additionally, the trust must meet state law requirements by being irrevocable unless the grantor and all beneficiaries consent or the termination is approved by the court.

1. SSI SNT Rules

A **d4A** trust instrument is presumed revocable with contrary language. To avoid disqualification for SSI public benefits under a **d4A** first party SNT, it is necessary to include a

specific provision of irrevocability. However, this provision must be carefully worded as the potential for transfer of assets despite an “irrevocability clause” can render the clause inadequate and the trust invalid. To avoid any such risk, it is advisable to name an individual remainder beneficiary for the SNT rather than leaving it “to the beneficiary’s estate” or “to the beneficiary’s legal heirs.”

2. Medi-Cal Trust Rules

Under rules similar to the SSI trust rules, an irrevocable trust created under **d4A** containing the assets of a disabled individual under age 65 which is established for the benefit of the individual by a parent, grandparent, legal guardian, or court and which contains a payback provision is not considered the individual’s resource for Medi-Cal eligibility purposes until the trust assets are distributed.

3. Income Taxation of SNTs

A first party SNT is generally taxed as a complex trust under IRC § 661 unless the trust falls within the grantor trust definitions of IRC §§ 671-679. If the trust is a grantor trust, all income will be taxed directly to the grantor/“deemed owner” under IRC §§ 671-679. The trust will be treated a grantor trust if the trust is revocable, if the beneficiary has a reversionary interest or retains certain administrative powers, or if the beneficiary has the power to control beneficial enjoyment of trust assets. Generally, all but the last of these powers are not powers that the beneficiary retains over the SNT because retaining them threatens the beneficiary’s eligibility for public benefits.

C. Pooled SNTs

A **d4C** or pooled trust is another kind of trust that was authorized by the OBRA ’93 changes to Medicaid law. A pooled trust is a self-settled trust that is funded with the assets of the individual. A pooled trust will be exempted as a resource if it meets the following statutory requirements:

- It is funded with the assets of an individual with a disability.
- The trust is established and maintained by a non-profit association.
- A separate account is maintained for each beneficiary of the trust. However, for investment and management purposes, the trust funds may be pooled into one account.
- The trust account is established by the parent, grandparent, legal guardian of the individual, a court, or by the individual himself.

- To the extent that any funds remaining at death are not retained by the trust, the state must be reimbursed for the amount of medical assistance advanced to the individual.

Though pooled trusts still require an irrevocability clause to be in the joinder agreement between the beneficiary and the non-profit association, there are a couple of differences in the creation of a pooled trust and other first party trusts. **First a pooled trust can be signed into for resources acquired after age 65.** However, there is still the penalty period of 30-60 months for adding such resources. However, this penalty is only for the purposes of Medi-Cal payments for nursing home care and does not apply to other benefits. Second, a **d4C** pooled trust can be created by the individual beneficiary if he or she is competent. This is relevant to rectifying poor estate planning, discussed later.

D. LSNTs

A litigation special needs trust (“LSNT”) is a unique option, first created in California law, for the management in trust of litigation proceeds for a disabled plaintiff where any judgment or settlement is paid to the trustee of an SNT. The LSNT only exists as a first party trust, regardless of whether it is through **d4A** first party trust or **d4C** pooled trust safe haven.

1. (Three) Requirements/Limits on LSNTs:

a. The minor or person with a disability must have a disability that both (i) substantially impairs the individual’s ability to provide for his or her own care or custody; and (ii) constitutes a substantial handicap. In practice, a person who already qualifies for SSI or Medi-Cal on the basis of disability is likely to satisfy the substantial impairment requirement.

b. The court must determine that the person is likely to have special needs that will not be met without the trust. The determination is based on the projected needs of the beneficiary for the entire term of the trust. Since most SNTs are for the life of the beneficiary, the court must determine if funds will be necessary at any time during the life of the beneficiary to supplement public benefits.

c. The amount to be paid to the trust may not exceed the amount that appears to be reasonably necessary to meet the special needs of the minor or person with a disability. In determining the amount reasonably necessary to meet the person’s special needs, the focus should be on the income generated by the trust. If the income produced is sufficient to cover the person’s anticipated supplemental needs, no depletion of trust principal will occur.

Preservation of principal will ensure that the trust assets are sufficient to provide for the disabled person's special needs throughout his or her life.

2. Procedure for Obtaining Court Approval to Establish LSNTs

To obtain court approval for establishment of an LSNT, a petition must be brought by the guardian, conservator, or any interested person (if there is no guardian or conservator). Notice should be petition hearing and a copy of the petition should be sent to the directors of the Department of Developmental Services, Department of Health Services, and Department of Mental Health at least 15 days before the hearing.

The proper court for hearing the petition is the court approving the settlement or giving judgment in the underlying proceeding. After the LSNT is approved, the court may transfer continuing jurisdiction to the court "in the proper county for commencement of a proceeding."

Additionally, the order approving the establishment of the LSNT must state that the trust is subject to the continuing jurisdiction of the court and may provide that the trust is to be subject to court supervision under the Probate Code. Unless the court otherwise orders for good cause shown, the LSNT document must also adhere to the requirements of other court rules.

An LSNT may be terminated upon petition by the claimant to the court at any time the requirements of Prob C § 3604(b) are not met, or the trustee refuses to make payments for the beneficiary's special needs without good cause; and a relevant state, county, or city agency has a valid claim against trust property. Otherwise, any claims by federal agencies are deferred until the beneficiary dies or the trust terminates.

Unlike most SNTs, a LSNT may be created by the court for an adult with capacity if he or she consents. This is generally allowed in the instance of elder abuse or where the individual is mentally capable but limited by a physical impairment to the point that he or she cannot reasonably provide for his or her own well-being.

3. LSNT Tax Issues

The funding and termination of LSNTs can trigger estate and gift taxes under certain circumstances.² In most instances, it is preferable to avoid gift taxes on funding of the trust.

² See IRS Letter Ruling 9437034. In that ruling, an LSNT was initially funded with a nominal amount by the plaintiff's mother, who was designated the trustor under the terms of the instrument. Under a settlement agreement, the defendants paid a lump sum to the trustee and agreed to make guaranteed installments for an additional ten years. The plaintiff died shortly after the trust was funded with only the initial lump sum payment. Under the terms of the trust, the plaintiff possessed a special power to appoint by will the principal balance of the LSNT remaining on his death.

Giving the beneficiary a testamentary special power of appointment, even if the beneficiary is not capable of exercising it, is essential to avoid making a completed gift. The trustee should, however, be prepared to file an estate tax return and pay estate taxes on the beneficiary's death if the value of the trust assets requires it. Special problems may be encountered in allocating and paying the estate tax if the trust is funded with an annuity that continues after a plaintiff's death, especially if the contingent beneficiary is a person other than the trustee of the LSNT. Note that any Medi-Cal reimbursement claim or other claim against the trust will be deductible from the beneficiary's gross estate as a claim against the estate under IRC § 2053.

III. OPTIONS AFTER INEFFECTIVE ESTATE PLANNING

Ideally, every person with a disability who is dependent on "needs based" government benefits and receives an inheritance will receive the inherited assets through a well-drafted third party SNT. However, uninformed family members or friends often leave assets outright or in a trust which is ineffective to preserve public benefits, with the distressing result that the beneficiary is confronted with the prospect of losing eligibility for SSI and Medi-Cal. Whether it is the inclusion of a "support and maintenance" clause or outright inheritance that disqualifies the beneficiary from public benefits, there are a number of methods for attempting to rectify any ineffective or failed estate planning when it comes to SNTs, including:

A. Modifying a Testamentary Trust

When a testamentary trust disqualifies a person with a disability from his or her benefits, it is typically best that the testamentary trust be modified into a third party SNT. There are several potential methods for accomplishing this task.

First, the document may contain language or have a mechanism that allows for amending terms of the trust in the document. In the event the language cannot be modified, a beneficiary

The IRS ruled as follows:

- Because the proceeds were from the settlement of a cause of action personal to the plaintiff, the plaintiff was the transferor of the funds placed in the trust, even though the plaintiff's mother was designated as the "trustor."
- The transfer of funds to the trust constituted an incomplete gift under Treas. Reg. § 25.2511-2(b), because the plaintiff had the power to change the disposition of the trust corpus on his death through the exercise of a special testamentary power of appointment. This means that funding the trust with the proceeds was not a gift and had no gift tax consequences. See §§ 2.15-2.18.
- Because the plaintiff as transferor retained a power to alter, amend, revoke, or terminate his interest in the trust, the trust corpus was includable in his gross estate under IRC § 2038(a)(1).

should seek to have the trust modified using Prob C §§ 15408-15409 or under the common law exception for “unique or peculiar” circumstances. *Ike v. Doolittle* (1998) 61 Cal. App. 4th 51.

Under Prob C 15409 and common law, the trust can be modified if there are changed circumstances. To determine if this is appropriate, the court asks three questions:

- What are the purposes of the trust?
- Would the continuation of the trust under its terms defeat or substantially impair their accomplishment?
- If so, is it because of circumstances not known or unanticipated by the settlor?

If the court determines that the intent of the trust was to provide for protection of public benefits when the inheritance was transferred to the trust and that settlor either did not know of the weakness of the instrument or did not anticipate the changes that invalidated the trust, the court will grant a petition to modify the trust.

As for Prob C § 15408, it is only useful when the principle in the trust is under \$20,000 or the trust is otherwise uneconomical to administer. In such circumstances, the trust can be terminated or modified to allow distributions that the beneficiary could “spend down” to maintain public benefits.

B. Options with Outright Inheritance

Depending on the answers to the following questions, it may be possible to establish either a **d4A** disability SNT or join a **d4C** pooled SNT in order to preserve public benefits

- Does the person have capacity to execute a power of attorney? If the person lacks capacity, is that person conserved?
- What is the person’s age?
- Does the person have a living parent or grandparent who has capacity and is willing to assist?
- Where are the assets coming from?

1. Disabled Person with Capacity and Living Parent or Grandparent

In this instance, the disabled person should set up a **d4A** first party SNT by executing a power of attorney authorizing his or her parent or grandparent to establish the SNT. The (grand)parent should then execute the **d4A** SNT as the settlor and transfer the inheritance into the SNT. The disabled person in this situation could also join a **d4C** pooled SNT, but the cost of establishing and administering a **d4A** SNT is generally less than joining a pooled SNT.

2. Disabled Person with Capacity and No Living Parent or Grandparent

In this instance, the disabled person can either join a **d4C** pooled SNT or seek to establish a **d4A** first party SNT through a court proceeding. To accomplish the **d4A** SNT, the disabled person would execute a power of attorney authorizing a friend or relative to petition the court. However, a court proceeding is generally lengthy and expensive. The determining factor for which SNT to pursue is the amount of inheritance. A large inheritance probably warrants a court proceeding, while a small inheritance suggests joining a pooled SNT.

3. Disabled Person (18-65) without Capacity and Is Conserved

For a benefits recipient who is conserved, the substituted judgment procedures authorize the establishment of a SNT. It is suggested to notice the State Director of Health Services, the Director of Mental Health, and the Director of Developmental Services in Sacramento. Prob C § 3611(c). Additionally, the trust must conform to Rule of Court 7.903.

4. Disabled Person (18-65) without Capacity and Not Conserved

In this situation, an option is to petition simultaneously to establish both the SNT (as described above) and a conservatorship. Though this is costly, the alternative is to do the petitions separately, which is even more costly.

In some jurisdictions, the court will allow an order by the court as the precedent to a petition to establish a SNT. In those jurisdictions, the process can be expedited.

5. Disabled Person (Under 18)

In many instances, a minor's inheritance need not be immediately transferred into a SNT because most minors are ineligible for needs-based public benefits because of deeming. Upon reaching 18, he or she may transfer the assets into a **d4A** SNT or pooled SNT as outlined above.

If the minor is somehow eligible for needs-based public benefits, the standard procedure under Prob C § 3610 should be followed after a court order is issued relating to the assets, as is done with a non-conserved disabled adult. The size of the inheritance and the certainty of the minor's disability will determine whether a **d4A** or **d4C** pooled SNT is preferable.

6. Disabled Person (Over 65)

Though a disabled person over 65 can spend down the assets, establish a personal care contract, purchase exempt resources, or other accepted transactions permitted by Medi-Cal, unfortunately, the **d4A** first party SNT is not available in this situation. However, the **d4C** pooled SNT may be. There are no age restrictions on joining pooled SNTs. As a result, a disabled person over 65 who receives an inheritance could join such a **d4C** SNT. Unfortunately,

there is still a penalty that would disqualify the person from nursing facility and similar institutional care for a period of 30 to 60 months. Thus, in the narrow circumstances where the person is over 65, disabled, and not in a nursing home or expecting to be transferred to one, it could be beneficial to join a pooled SNT and transfer the inherited assets. The procedure for doing so is the same as listed above (depending on whether the individual has capacity or is conserved).