The Intersection of Retirement Income Planning and Special Needs Planning

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Introduction

In recent years, a number of academics and practitioners have made significant strides in the field of retirement income planning. As members of the Retirement Income Industry Association (RIIA) are aware, these sophisticated strategies help financial professionals work with their clients to have adequate financial resources throughout their retirement.

Over the same time period, a different set of professionals have refined strategies for helping address the needs of clients with a special-needs dependent. The financial challenges these families and individuals face often revolve around preserving eligibility for federal government benefits and ensuring adequate financial resources for the duration of the special-needs dependent's lifespan.

Interestingly, while both fields of study – retirement income planning and special-needs planning – have a unique set of "best practices" there has been little, if any, analysis of the intersection of these two disciplines. With this in mind, the purpose of this paper is to outline the most important intersection points between the best practices of retirement-income planning and special-needs planning. Intersection in this context means areas of conflict rather than areas of synergy, as resources either must support our clients in retirement, or must support their special-needs dependent, and generally cannot accomplish both goals.

It is important to point out that there are no simple answers for these areas of conflict; rather, these intersection points require a case-by-case analysis. Nonetheless, it is important for practitioners to understand these areas and, if necessary, involve other professionals to assist in designing adequate strategies for their clients, rather than blindly employing one strategy without regard for the other.

Please note that this paper assumes a healthy retiree and a special-needs dependent. It does not contemplate a scenario in which the retiree is the disabled individual, either when entering retirement or at some point during retirement. This alternative

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scenario warrants a completely distinct analysis of intersection points.

The Trends

Statistics suggest that an increasing number of individuals and families will, in the future, need a combined retirement income / special-needs planning approach:

- **The United States is aging.** According to the U.S. Department of Health and Human Services, individuals 65 or older represented 14.1% of the population in the year 2013 (the latest year for which data is available). By 2040, individuals 65 or older are expected to account for 21.7% of the population[1]. Not surprisingly, approximately 10,000 baby boomers turn 65 every day[2].
- **The ability for retirees to leverage reliable income streams continues to weaken.** Once widespread, defined benefit pension plans are now offered by far fewer employers. And while Social Security is still a viable source of retirement income, it continues to face challenges.
- **Special-needs diagnoses are growing.** Just one diagnosis alone – Autism Spectrum Disorder (ASD) – has risen rapidly in the last 10 years. In 2006, the Centers for Disease Control Prevention reported that one in 150 children had an ASD disorder; in 2014, 1 in 68 children had this disorder[3]. While perhaps the most widely reported, this upward trend is not unique among special-needs diagnoses.
- **The challenges for families with at least one member who is a special-needs individual are greater than ever.** In order for a special-needs individual to qualify for Supplemental Security Income (SSI) – and therefore, Medicaid – he or she must have no more than $2,000 in assets. Because this asset limit has remained constant over 40 years, proper planning and implementation has become more critical over time.

Background: Retirement-income Planning

For purposes of this paper, the retirement-income framework is consistent with RIIA's description of retirement planning: "First build a floor, then expose to upside."

As a starting point, the financial professionals help the client build a base of income through reliable sources to cover as much of the client's essential expenses as possible. Possible sources can include Social Security retirement income, defined benefit pension plans, immediate fixed annuities, and a Home Equity Conversion Mortgage (HECM).

The financial professionals then help clients establish a "bucket approach" for investable assets that divides the assets into "buckets" based on timeframe for usage, filling up each bucket with assets based on projected cash flow deficits during each time period. For example, the client may have a bucket of assets to be used in the first five years of retirement, a second bucket for years six through 10, a third bucket for years 11 through 15, and then a final bucket of assets to be used from year 16 until the death of the second spouse.

The financial professionals then suggest investment strategies for each bucket of assets according to timeframe, so that the bucket with the shortest timeframe is least sensitive to short-term market downturns and the bucket with the longest timeframe is most sensitive. While each bucket has its own investment allocation, the aggregate allocation of all investments matches the overall client tolerance for downside market risk.

If suitable, the financial professionals may also suggest that a portion of the client's assets be invested in deferred variable annuities with living benefit riders that provide the potential for lifetime guaranteed income. These products can often help with sequence-of-return risk.

Once the overall retirement investment and distribution plan has been initiated, the financial professionals then monitor the client's investable assets during retirement, sliding assets from longer-

term buckets into shorter-term ones as the client's planning horizon decreases and the shorter-term buckets are depleted. As necessary, the financial professional and the client may decide to "turn off" bucket depletion during periods of market volatility and temporarily curtail non-essential expenses.

Background: Special-needs Planning

As noted earlier, two primary financial objectives for special-needs planning are:

- Preserving eligibility for federal government benefits
- Ensuring adequate financial resources for the duration of the special-needs individual's lifespan

To meet the first objective – preserving eligibility for federal government benefits – the special-needs individual cannot own more than $2,000 in assets (which includes the value of investments, cash, artwork, jewelry, U.S. Treasury Bonds, and real estate, among other asset categories). These benefits will generally cover medical, boarding, and other necessary living expenses for an individual with a disability to live in a special needs facility or allow the individual to remain in the community, whether as a fully independent person or as a dependent of the homeowner. However, most special-needs individuals have additional wants and needs beyond basic living expenses, from clothing and grooming expenses, to vacations, to magazine, media, and internet subscriptions.

In order to have assets available for the special-needs individual's financial needs, it is common to establish and fund one or more special-needs trusts. The two most common special-needs trusts are "third-party" trusts and "first-party" trusts.

- The "third-party" trust is structured to supplement, not supplant, the benefits available through government programs. Quite often, the caregivers of the special-needs individual will establish the trust and fund it with assets gifted to the special-needs individual. Assets from the trust are not given to the special-needs individual; rather, they are paid directly to third parties who provide services for the individual.
- The "first-party" trust (also known as a (d)(4)(a) Trust or OBRA 93 Trust, based on the section of the Social Security Act that was amended to allow these gifting techniques) is also structured to supplement, not supplant, the benefits available through government programs. It allows the special-needs individual, once reaching age of majority, to move assets out of his or her name. These trusts can only be established and funded for an individual under the age of 65 by a parent, grandparent, guardian or by court order. One major disadvantage is that assets remaining in the trust after the death of the special-needs beneficiary must first be used to reimburse the State's Medicaid program before being distributed to other desired beneficiaries or charities.

Properly established special-needs trusts therefore provide several distinct advantages over other trusts: Neither the corpus of trust assets nor the subsequent income generated by the corpus interfere with the special-needs individual's classification as "needy" in order to qualify for benefits, and there are no transfer penalties or gift taxes associated with the actual funding of the special-needs trust.

It is worth noting that pooled trusts, which are set up and trusteed by certain non-profit organizations, are, at times, viable options towards meeting the same objective. In addition, it is possible that "ABLE" accounts, which were established by the Achieving a Better Life Experience (or ABLE) Act in December 2014, may also play a role in the future for some families once individual states develop their own programs and infrastructures.

In order to meet the second objective – ensuring adequate financial resources for the duration of the special-needs dependent's lifespan – various strategies can be employed. These include saving

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regularly, deploying an investment allocation strategy consistent with long time horizons, and aggressively seeking out government programs to reduce expenses for the family of the special-needs dependent.

One very common technique is to purchase survivorship, or "second-to-die" life insurance. With this product, the death benefit is paid to the beneficiary (in this example, the "third-party" trust) upon the death of the second parent or caregiver. With this approach, the trust is funded precisely when it is needed the most, and if constructed properly, avoids payment of estate and income taxes.

The Intersection Points

Against this backdrop, there are four troublesome intersection points between retirement-income planning and special-needs planning:

Intersection #1: The Buckets

As described earlier, the "bucket approach" is designed to match cash flow needs of the retired client, turning off bucket depletion when necessary to ensure assets will last. This approach becomes problematic when there is a special-needs dependent, particularly when the dependent is likely to outlive his or her caretakers.

While the family expenses required to care for a special-needs dependent vary considerably, they can be staggering. In fact, the combination of essential expenses for medical needs, housing, daycare, and day-to-day living can exceed the expenses – essential and non-essential combined – of a retired couple. As a result, the necessary floor of reliable, predictable income for that couple increases dramatically and there is less tolerance for downside market volatility. In practice, it can be necessary to manufacture more streams of reliable income, with the specific techniques or products varying from client to client.

In situations where the caretakers are likely to predecease their special-needs dependent, a new – and large – bucket emerges to fund the dependent's financial needs after the caretakers' lifetime. As terrifying as it can be to confront, the caretakers need to realize that they must plan for an additional lifetime need. From a "bucket approach" standpoint, in practice it either raises the floor of reliable income even higher, in order to ensure assets are left for the dependent, or it creates the need to manufacture a bucket of assets upon death with survivorship life insurance.

Intersection #2: Social Security

Conventional wisdom suggests that individuals should wait to file for Social Security retirement benefits at least until Full Retirement Age (FRA) – and longer if there is a history of longevity in their family and they are in good health. The 8% year-over-year benefit increase by waiting to claim can benefit the "typical" client and create a larger floor of reliable income.

The presence of a special-needs dependent makes the situation more complicated. Under current Social Security rules, a Disabled Adult Child (DAC) can collect on a parent's records once a parent is deceased, disabled, or retired. In the case of retirement, the DAC can collect up to 50% of the parent's retirement benefit calculated at the parents' Full Retirement Age, regardless of when the parent actually files[4]. In other words, the DAC is not penalized if the parent files at age 62 – in fact, the DAC receives up to five extra years of Social Security Disability Income (SSDI) by starting the payments as early as possible.

There are two additional complications, however:

- **The Family Maximum.** The Social Security Administration has established maximum benefits for a family. In cases where multiple family members are paid on a worker's earning record, or where the worker's retirement benefit is starting from a high point, the total

amount payable to the family can be reduced.

- **The Interplay Between SSI and SSDI.** SSI is a needs-based Federal Government program and, as noted earlier, individuals on SSI automatically receive Medicaid. Given the medical expenses of some special-needs individuals, as well as the breadth of other unique programs under various state's Medicaid programs (such as career training and access to service animals), many families try to receive at least one dollar of SSI as long as possible. SSI is reduced, however, by dollars the special-needs individual receives from SSDI, and it is not uncommon for SSI to be completely eliminated because of the SSDI payments. As a result, it may not be in the family's financial interest to maximize SSDI benefits.

Finally, the unfortunate reality of special-needs planning is that the divorce rate among couples caring for their dependent is higher than the national average. Consequently, the Social Security claiming strategies become even more complex when determining benefits from an ex-spouse.

Intersection #3: Prioritization of Withdrawing Assets in Retirement

When depleting investable assets in the various buckets, the client needs to address prioritization: Should qualified assets be depleted before non-qualified assets, or vice versa? Because retirement assets can be bought and sold without creating a taxable event (provided they stay within some sort of retirement account), and because these assets are taxed as ordinary income upon distribution, financial professionals often recommend that clients withdraw non-qualified account assets before withdrawing more than the minimum amount required annually out of qualified accounts.

For families with at least one member who is a special-needs individual, that prioritization can be suboptimal. If non-qualified assets are depleted first during retirement, then assets passing to the next generation are more likely to be qualified assets. Qualified assets can be left to a special-needs trust, but the ability to "stretch" the distribution of these assets within a special-needs trust (in order to delay payment of income taxes) can, in certain circumstances, be compromised. In fact, if any of the special-needs Trust's beneficiaries – primary or contingent – is not a human being, then the retirement assets must be paid out within five years upon death of the original owner.

Therefore, if the caretakers of a special-needs dependent do not have other human beings as desired beneficiaries – and are therefore likely to name a nonprofit as the contingent beneficiary – then they may want to deplete their qualified assets in their lifetime, leaving their non-retirement assets to their special-needs dependent.

Furthermore, if the caretakers of a special-needs dependent have other desired beneficiaries, such as other children, then they may plan to pass along qualified assets to the other beneficiaries. If that is the case, then the prioritization of asset distribution during the caretakers' lifetimes is partly dependent on the anticipated future needs of all of the beneficiaries, including the special-needs dependent. Given the high anticipated future needs of the special-needs dependent, the caretakers may well decide to preserve as much of the non-qualified assets as possible – and spend down the qualified assets.

There is, potentially, one other practical issue related to transferring qualified assets to a special-needs trust. Because required minimum distributions must be withdrawn from qualified assets, there may be more assets required to be distributed in a given year than is necessary to pay for the services of the special-needs dependent. This scenario could create operational complexity that the trustee or trustees would rather avoid – or, worse case, it could jeopardize the special-needs dependent's eligibility for federal government benefits.

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On a related note, it is worth pointing out that retirement benefits are controlled by the beneficiary form associated with the particular retirement account. When establishing a special-needs trust and other estate planning documents, the client will want to revise the beneficiary forms of these accounts so that the special-needs trust is listed as the beneficiary, not the special-needs dependent. If the dependent is the beneficiary of a qualified account outright, then they may well exceed the $2,000 SSI limit.

Intersection #4: The Home

Clients can purchase a HECM to help increase the "floor" of reliable income during their retirement. Under the typical reverse mortgage arrangement, as long as all owners have attained age 62, then the homeowner takes out the mortgage in return for a stream of monthly income that is paid out over a predetermined number of years. At the end of the term period – which is typically the death of the second spouse – the homeowner (or the estate) will need to pay off the mortgage. This situation typically requires relinquishing ownership of the house at death.

With a special-needs dependent, the individual may be living in the caretaker's house and need to continue living in that house long after the caretakers have passed. The caretakers may determine that the special-needs dependent should stay in the house after they have passed because of medical reasons (because particular equipment is already in place and is difficult to move), financial reasons (because it is more cost effective to stay in a mortgage-free home with a new caretaker than to purchase a new piece of property), or comfort reasons (because the special-needs dependent may have significant emotional issues if required to move to a new environment).

As a result, the client should assume that he or she will predecease the special-needs dependent and plan for all facets of the special-needs dependent's life once he or she has passed when evaluating a HECM.

Conclusion

While this paper addresses the intersection of retirement-income planning and special-needs planning in four specific scenarios, it is not an exhaustive list. During the fact finding with the client, including the discussion of values and goals, the financial professional will almost certainly uncover others. For this reason, it is imperative for retirement-age clients who have a special-needs dependent to start the planning process early with financial professionals who understand the complexities and who are willing to devote the time needed to evaluate various options. ■

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Footnotes:

1 Source: http://www.aoa.acl.gov/Aging_Statistics/index.aspx
2 Source: http://www.pewresearch.org/daily-number/baby-boomers-retire
3 Source: http://www.cdc.gov/ncbddd/autism/data.html
4 This technique remains even after April 2016, as it does not require the parent to file and suspend.