TORT SETTLEMENTS AND DISABILITY PLANNING:
Using Special Needs Trusts in the Context of Tort Settlements and Guardianships

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I. Introduction to Special Needs Trusts.

A. SNT background.

1. Designed generally to provide for non-support, supplemental care needs.

2. Generally not designed to provide for food, clothing or shelter ("ISM").

a. Fully discretionary, with precatory special needs language?

b. Fully discretionary, prohibiting distributions for ISM?

c. Fully discretionary, but authorizing trustee to provide in-kind support if trustee deems that beneficiary's needs will be better met in spite of the partial reduction in SSI benefits or Medicaid?

B. Types of SNTs by creator.

1. Third Party Trusts.

a. Created and funded by someone other than the person receiving benefits.

b. In most cases, trusts created with personal injury settlements will fall in the "self-settled" category.

c. For self-settled trusts, both Medicaid and SSI rules are very restrictive.

d. If a trust is fully discretionary and not created for a spouse, and established properly by a third party, it will generally have no public benefits consequences.

e. In general, in the case of a spouse, a third party SNT can only be created by means of a testamentary trust.

f. Must consider the possibility of estate recovery against the estate of a surviving spouse following the death of a surviving spouse in the context of Medicaid.

2. Self-settled trusts.

a. Trusts created with personal injury settlements will generally be "self-settled".

b. For self-settled trusts, both the Medicaid and SSI rules are very strict regarding the trusts that are allowed to be exempt for eligibility purposes.

c. Trusts that do not meet a safe harbor will be counted as belonging to the applicant/recipient, rendering him or her ineligible for benefits.

3. See "Asset Preservation and the Importance of Special Needs Trusts" by Randall K. Craig (may be accessed at *www.rkcraiglaw.com*).

II. Safe Harbor Trusts.

A. 42 U.S.C. §1396p(d)(4)(A) [SSA §1917(d)(4)(A)] Trusts.

1. (d)(4)(A) disability trusts must be established by a parent, grandparent, a legal guardian, or the court, with the assets of a Medicaid or SSI beneficiary who is under 65 years of age.

2. Even though established by the parent or other permissible creator, the assets of the beneficiary may be used to fund the trust.

3. Does not give rise to a Medicaid or SSI transfer penalty, and the assets in the trust are protected as long as they are used to provide for the "supplemental needs" of the beneficiary and not for general support.

4. Income will generally be attributable to the beneficiary for income tax purposes.

5. The trust must provide that any sums remaining in the trust upon the death of the beneficiary will be used to repay the state for Medicaid expenditures.

B. 42 U.S.C. §1396p(d)(4)(B) [SSA §1917(d)(4)(B)] Trusts.

1. This is the co-called "Miller" trust or "qualified income trust" which will apply most frequently in states which impose an income limit for Medicaid eligibility purposes.

2. This trust consists solely of pension, social security and other retirement income, plus accumulated income on those trust amounts.

3. As in the case of a (d)(4)(A) trust, a (d)(4)(B) trust must provide that any sums remaining in the trust upon the death of the beneficiary will first be used to repay the state for Medicaid expenditures.

4. This type of trust becomes the assignee of all periodic income, and the income so assigned does not count toward Medicaid eligibility.

5. Has less usefulness in Indiana, which is not an "income cap" state, but can be helpful for certain waivered services.

C. 42 U.S.C. §1396p(d)(4)(C) [SSA §1917(d)(4)(C)] Trusts.

1. This kind of trust is the so-called "pooled trust" or "non-profit association trust," which is established as a master trust by a charitable organization which is responsible for management of the trust.

2. Examples of a (d)(4)(C) "pooled" trust are the SWIRCA Pooled Trust established by Southwestern Indiana Regional Council on Aging, Inc. and the ARC of Indiana Master Trust.

3. A trust "sub-account" is established for the particular beneficiary under the penumbra of the master trust, which may be established with the beneficiary's assets by the beneficiary himself as well as a parent, grandparent, legal guardian or the court.

4. As with the (d)(4)(A) trust, the income may be attributable to the beneficiary for income tax purposes, and there is no transfer penalty, except for transfers of a beneficiary's own assets if the beneficiary is 65 years of age or older.

5. As in the case of the (d)(4)(A) and (d)(4)(B) trust, there is a "pay-back" requirement to the state Medicaid agency for reimbursement of medical expenses.

   a. However, there is an exception in the case of a (d)(4)(C) trust to the extent that the remaining assets stay in the trust following the death of a beneficiary.

   b. A "pooled trust" sub-account is a very helpful mechanism for a disabled beneficiary when there may not be a family member available to hold or administer assets in conjunction with another arrangement, such as a (d)(4)(A) trust, or when the assets available for protection are so small as to make it difficult to justify utilization of a private trust.

III. Benefits Consequences of Transfers to SNTs.

A. Omnibus Budget Reconciliation Act of 1993 ("OBRA 93") established general rules for assets disposed of and trusts created after August 10, 1993.

1. "Look-back" period is 36 months for direct transfers, and 60 months in the case of certain transfers to or from a trust.

2. A significant change was effected by the Deficit Reduction Act of 2005 (generally referred to either as "DRA" or "DFRA"). Pub. L. No. 109-171.

   a. The DRA extends the look-back date to a date that is 60 months in all cases after February 8, 2006, the date of enactment, subject to an extension of the effective date provisions to accomplish certain state law amendments. DRA §6016(E)(3).

b. Indiana has not yet enacted legislation or regulations to incorporate the federal requirements.

3. There is currently no penalty, speaking generally, for a person at home receiving regular Medicaid except in the case of certain waivered services.

4. The penalty period is determined by dividing the value of the property transferred by the so-called "divestment penalty divisor", which for Medicaid applications filed on or after July 1, 2006, is $3,960.

5. SSI program has similar rules, except that the "look-back" period is always 36 months and the penalty is calculated by dividing the amount transferred by the maximum SSI benefit (in Indiana, since there is no state supplement, the current individual benefit level is $603, which will increase to $623 on January 1, 2007).

6. Other benefit programs may also be impacted by transfers, such as the Section 8 and VA programs.

   a. Information concerning the VA program can be obtained from *www.va.gov* and *www.vba.va.gov/benefits/address*.

   b. Information concerning the Section 8 program can be obtained from *www.hudclips.org*.

B. Although the tax consequences of SNTs are beyond the scope of this presentation, a few issues must be addressed.

1. A "safe harbor" trust will generally be a "grantor trust" for federal and state income tax purposes.

2. A third party created trust will usually be a "complex trust" for federal and state income tax purposes.

   a. A SNT that is the designated beneficiary of a retirement plan or account which is a complex trust and subject to the trust income rules found at IRC Section 641 *et seq.* can result in significant income taxation if the income is not distributed, and a loss of benefits to the beneficiary if the income is distributed.

   b. Consequently, the possible "trapping" of income must be carefully analyzed and avoided.

3. PLR 2006 20025 addresses the possibility of transferring an "inherited" IRA to a SNT for the beneficiary which is treated as a grantor trust for income tax purposes.

IV. Guardianship Implications.

A. I.C. 29-3-9-4(a).

1. I.C. §29-3-9-4(a) provides that the court may authorize a guardian to apply or dispose of either the principal or the income of the estate of a protected person to carry out any estate planning that the court determines to be appropriate for any purpose the court decides is in the best interest of the protected person or the protected person's property, spouse, or family.

2. I.C. §29-3-9-4(b) provides that the court shall determine whether the planned disposition is consistent with the apparent intention of the protected person, and in the absence of evidence as to the declarations, practices, or conduct of the protected person, the court may make a determination on the basis of what a reasonable and prudent person would do under the same or similar circumstances as shown by the evidence presented to the court.

3. I.C. §29-3-9-4(c) provides that the guardian may examine the will of the protected person in conjunction with the planning being undertaken.

B. Very little Indiana law exists regarding the implications for or any limitations on the power of a guardian to undertake special needs trust planning for a person under guardianship.

1. See In The Matter of the GUARDIANSHP OF E.N., Adult, N.E.2d, 2006 WL 2457484 (Ind.App.).

2. The E.N. case was not a special needs trust or Medicaid planning case, but involved a plan establishing a trust for E.N. in which virtually all of the assets could be spent during his lifetime only for his best interest and only for his benefit and welfare. The court held that the over-arching purpose of I.C. 29-3-9-4 is that a plan to dispose of a protected person's assets should be approved only if it provides, to the greatest extent possible, support for the protected person during the protected person's lifetime. The protected person's property exceeding the amount needed to provide for his support may be disposed of as long as the disposition is in the best interest of the protected person or the protected person's property, spouse or family. In considering the planned disposition, the court should consider whether the planned disposition is consistent with the apparent intention of the protected person as expressed in the protected person's declarations, practices or conduct of the protected person. Lacking such evidence, the court may consider what a reasonable and prudent person would do under the same or similar circumstances.

3. The court stated, as *dicta*, that a guardian may, or may not, adopt an estate plan that effectively rewrites a protected person's will, depending on whether that course of action is deemed by the court to be in the protected person's best interest.

4. It is interesting that the facts of E.N.'s case were that he had made several wills over the years, and that following a dissolution of marriage, he had executed a will divesting his ex-wife and children and leaving his entire estate to his brothers. Later, one of the children had petitioned for and been appointed as guardian, after he had executed another will naming the children as his sole beneficiaries.

   a. The proposed estate plan would have established a typical revocable trust with the assets at death to be distributed to the children and the children's children.

   b. The trial court authorized an estate plan which allowed the establishment of the trust and the transfer of the assets to the trust, but required that the brothers be designated as beneficiaries of several life insurance policies and an annuity.

   c. In effect, the court allowed an estate plan which transferred all of E.N.'s assets into a trust and effectively rewrote his will, making the will meaningless by leaving no assets to be disposed of by the will.

C. It may be helpful to look at other state court decisions relating to Medicaid planning.

1. Courts in other states have addressed the public policy aspects of Medicaid planning in the context of a court-supervised guardianship and have found generally not only that there is no public policy prohibition against Medicaid planning and transfers of property, but in fact that public policy dictates that guardians should be permitted to engage in Medicaid planning in behalf of a person under guardianship.

2. In Matter of Klapper 72 N.Y.2d 806, 529 N.E.2d 177, 532 N.Y.S.2d 847 (NY 1988), the judge states very succinctly that:

> To deny a guardian the authority . . . to make [a] transfer of the incapacitated person's assets would result in denying that person the opportunity which is available to all competent persons . . . . who require long-term nursing home care and who have assets they desire to gift to their families, simply because he or she is incapacitated and is unable from a cognitive standpoint to make such transfer himself or herself.

3. In The Matter of Kashmira Shah v. Helen Hayes Hospital, et al., 694 NYS2d 82 (NY 1999) the Appellate Division of the Supreme Court of New York stated:

> The complexities of the Medicaid eligibility rules, not to mention the complexities of

> State and Federal law concerning gift and estate taxation which often come into play as hapless middle-class Americans seek to save themselves from financial ruin as the result of astronomical nursing home costs, should never be allowed to blind us to the essential proposition that a man or a woman should normally have the absolute right to do anything that he or she wants to do with his or her assets, a right which includes the right to give those assets away to someone else for any reason or for no reason. In other words, it is, or should be, clear that Mr. Shah, who had the unrestricted right to give his assets to his wife, or to his children, or to anyone else for that matter, at all times up to the moment of his terrible injury did not, on account of that injury, lose that fundamental right merely because he is now incapacitated and financial decisions on his behalf must necessarily be made by a surrogate . . . . There can be no quarreling with the Supreme Court's determination that any person in Mr. Shah's condition would prefer that the costs of his care be paid by the State, as opposed to his family.

4. In The Matter of Keri, 181 N.J. 50, 853 A.2d 909 (NJ 2004), the Supreme Court of New Jersey reversed the Trial Court and stated as follows:

> The New Jersey cases we have reviewed support the petitioner's claim that when a Medicaid spend-down plan does not interrupt or diminish a ward's care, involves transfers to the natural objects of a ward's bounty, and does not contravene an expressed prior intent or interest, the plan, *a fortiori*, provides for the best interests of the ward and satisfies the law's goal to effectuate decisions an incompetent would make if he or she were able to act.

5. See also "Substituted Judgment: Estate and Medicaid Planning by Guardians," by Edwin G. Fee, Jr., *Probate and Property*, January/February 1999, p. 13, *et seq.*; "Guardianship Medicaid Planning, Estate Planning from Probate Court Perspective," William R. Fatout, 43 Res Gestae 21 (July

1999); "Medicaid Planning by Guardians," National Academy of Elder Law Attorneys 2003 Institute, by Ellice Fatoullah and Paul A. Sturgul.

V. Settlement of Personal Injury Claims.

A. Types of settlements.

1. Lump sum.

2. Structured settlement.

3. Combination of both.

B. Settlement issues.

1. The U.S. Centers for Medicare and Medicaid Services ("CMS") has ruled structured settlement payments paid directly to a (d)(4)(A) SNT are not the beneficiary's income and cannot be counted in the beneficiary's share of care costs.

   a. However, some SSA regional offices have taken the position that structured settlement annuity payments made to the trustee of a (d)(4)(A) SNT are countable as income directly to and against the disabled beneficiary.

   b. Since the SSA is not bound by the rules of the CMS, structured settlements must be used with caution.

   c. The Program Operations Manual System ("POMS") should be consulted for special SSI requirements. These can be accessed on line at *http://policy.ssa.gov/poms.nsf*.

2. For smaller settlements, it may be advisable to take a lump sum to avoid the cost of creating and administering a small SNT.

3. In the case of a small settlement, a lump sum can be placed into a (d)(4)(C) SNT or spent down in such a way as to protect public benefits (exempt purchases would include a home, motor vehicle, funeral prepayment, etc.).

4. For larger settlements, some part or all of the settlement can be taken in a lump sum and invested in exempt resources and/or paid to a (d)(4)(A) or (d)(4)(C) SNT.

5. For larger settlements, a portion of the recovery could be structured, which should include a commutation provision or payment on death provision, to permit the payment of estate taxes and a Medicaid claim.

   a. Obviously, if the settlement is large enough, SNT planning may not be necessary as the amount may be sufficient to provide for all of the

beneficiary's reasonably foreseeable future needs, including medical care and prescription drugs, during his or her lifetime.

b. Alternatively, at some point in the future, the SNT could be established if and when it may become appropriate to do so.

C. Structured Settlement Issues.

1. Essentially a tax-advantaged annuity, i.e., a contract with an insurance company to make fixed payments, usually monthly, to the beneficiary.

a. Typically will pay for life with a guaranteed term certain (e.g., 20 years, even if the beneficiary dies before the end of that period, with the balance of the payment going to named remaindermen).

b. The tax advantage is that the payments are never taxed, even though the payments include the value of the lump sum settlement plus earnings.

c. They are generally viewed as virtually risk free, assuring the attorney that the client will receive the benefit for life, and will not be subject to investment acumen or lack thereof.

2. The drawbacks of a structured settlement include its lack of flexibility.

a. Does not permit major purchases, such as a house or handicapped van.

b. Can destroy a client's current and future eligibility for public benefits.

c. Can create estate tax problems, although this can be avoided through the use of a commutation rider.

d. It is rigid, locking in the investment at the prevailing rate at the time of the settlement and not permitting the client to take advantage of investment opportunities.

D. Cash Settlements In Contrast.

1. Offer complete flexibility, both in terms of when funds will be available to make larger purchases, and to take advantage of and respond to fluctuations in the market.

2. The need for this flexibility is reflected in the thriving business of paying cash for structured settlements at a substantial discount.

a. IRC Section 5891 imposes a 40% tax on transfers not meeting federal requirements (i.e., approved in advance by a qualified court order).

b. State laws may require court approval. See I.C. 34-50-2-1, *et seq.*, and *In The Matter of: A Transfer of Structured Settlement Payment Rights by Roger L. Dunn*, 848 N.E. 2d 310 (Ind. App. 2006).

VI. Examples of Actual Cases Utilizing SNTs.

A. Guardian of elderly mother with approval of guardianship court transfers property to a (d)(4)(A) SNT for disabled daughter. Transfer of property did not affect Medicaid eligibility of mother, and in fact gave rise to Medicaid eligibility for mother, and did not affect Medicaid or SSI eligibility of daughter. This trust still exists after at least seven years and provides a supplemental care fund for the daughter who is currently approximately 56 years of age and remains disabled.

B. Settlement of personal injury claim allowed parents to establish (d)(4)(A) SNT for disabled son utilizing personal injury settlement payable to disabled son. The parents were the creators of the SNT but the settlement proceeds belonging to son were transferred directly to SNT and did not affect SSI or Medicaid eligibility of disabled son, except for the month in which the settlement was received.

C. Wife, a guardian for husband who was admitted to a long term care facility, was authorized to engage in Medicaid planning in order to preserve assets for the wife and allow the husband to become eligible for Medicaid. Later, when husband was able to return home, the Medicaid waiver rules would have rendered husband ineligible for Medicaid in-home services because husband's income was in excess of the "special income limit" ("SIL"). Guardianship court allowed wife as guardian to establish (d)(4)(B) SNT for husband to receive all of husband's income and to pay out to husband the allowed monthly income amount (currently $1,809 per month for in-home waivered services, but increasing to $1,869 on January 1, 2007), with remaining income to be used for "special needs" purposes.

D. Niece who was the guardian of her institutionalized aunt was allowed by guardianship court to transfer a sum of money to the SWIRCA Pooled Trust, a (d)(4)(C) SNT, and used remaining resources of institutionalized aunt to pay for her care. When remaining resources were consumed, disabled aunt became eligible for Medicaid and the SNT funds still exist in the SWIRCA Pooled Trust Sub-account to provide for supplemental care of aunt who is now eligible for Medicaid.

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