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Trusts & Estates Forum

Protecting Personal-Injury Awards With SNT's

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So you made it into Massachusetts Lawyers Weekly's Top Ten Jury Verdicts of 2001. Time to kick back and enjoy the spoils? Not quite. It's true you've conquered the first formidable challenge of the successful personal injury attorney: Developing and presenting a client's case in a manner resulting in the best recovery for the client. But the follow-up is just as important: Seeing that the maximum amount of the settlement is preserved for the benefit of your client without jeopardizing the client's eligibility for governmental benefits or exposing the client to unnecessary taxes. This discussion will examine ways to meet the second challenge where the client is disabled and, but for the recovery, is or would be eligible for Supplemental Security Income ("SSI") and Medicaid benefits. (Medicaid is administered in Massachusetts through the MassHealth program.) If you need a refresher course on the nuts and bolts of benefit eligibility, we recommend *An Advocate's Guide to Surviving the SSI System* by Linda L. Landry (Editor) and the good folks at the Boston-based Disability Law Center, Inc. For our purposes, remember that eligibility for SSI automatically brings eligibility for Medicaid, and that Medicaid differs from Medicare.

A successful client (through family or representatives) must first face the issue of dealing with any state or federal liens against the settlement proceeds. There is little choice as to the Medicare and Medicaid liens (there is no SSI lien), and to avoid personal liability the attorney must be certain that such liens are paid according to the applicable law before dispersing recovery proceeds. To make things interesting, Medicare and Medicaid liens are not treated the same, and Medicaid liens are not treated the same in all cases. For example, Medicare has priority over Medicaid to recover benefits paid from amounts received from a third party payor (such as a defendant in a personal injury case) and must be satisfied in full before the payment of the Medicaid lien, although Medicare will reduce its priority lien by its proportionate share of the procurement costs incurred in obtaining the award (including legal fees), while Medicaid does not. Compare generally Mass Gen L. chap. 118E, §22 with 42 C.F.R. 411.37. Additionally, the Medicaid lien can be enforced against the entire proceeds of the recovery, not just the portion that the parties or the court have allocated to past medical expenses. Whelan v. Division of Medical Assistance, 44 Mass. App. Ct. 663, 694 N.E.2d 10 (1998). Finally, Medicaid liens come in various forms and are recoverable at different times and from different funds depending upon when the benefits had been paid (pre-injury, post-injury and pre-settlement, or post-settlement). Tread carefully.

Once the liens have been satisfied, the client essentially has the freedom to do with the funds as he pleases. In the case of a disabled client who requires ongoing care, the most desirable objective would be to preserve the funds for the client's general well being and development while preserving any benefits (SSI and Medicaid) that may be available to him, with the hope that whatever funds are left at the client's death are ultimately available for the client's family, who in most cases have shared in the suffering of the client and his on-going care. A disabled client who receives a recovery and does no planning would be ineligible for benefits and thus would be required to spend virtually all of the recovery on his day-to-day care, leaving nothing to improve his quality of life or to leave for his heirs. Therefore, the trick is to meet the eligibility requirements even though the client now has substantial assets. In almost all cases, this objective can be met through one type of *benefit preservation trust*, commonly called a special needs trust (SNT), also referred to as a "supplemental needs trust", an "Under 65 trust", an "Under 65 special needs trust", and a "(d)(4)(A) trust" (after the statutory reference 42 U.S.C. 1396p(d)(4)(A) which authorizes such trusts). We'll use "Under 65 SNT".

The Under 65 SNT which meets the (d)(4)(A) statutory requirements offers special privileges to the client at a "bargain" price. That is, it allows the client who establishes such a trust to (i) immediately remain on or become eligible for benefits without a waiting or look-back period (normally 60 months), (ii) receive care at a discounted rate (the government pays less than private individuals do for the same care), (iii) defer repayment until death without interest, (iv) have the recovery proceeds available to provide for the client's supplemental care and comfort, possible improvement of his condition and quality of life, and (v) possibly leave at the client's death a sizeable portion of those funds for his family. In this light, it is important to note that the trust funds need not be invested to produce a predictable flow of income, as there is no statutory requirement to distribute a fixed amount of income from the Under 65 SNT to the beneficiary. Instead, the funds may be invested with an emphasis on long term growth, which would not only result in lower income taxes over the years but presumably would also result in a much larger trust fund to benefit the client during his lifetime, and to satisfy the liens and benefit the family at the client's death.

To meet the statutory requirements, the Under 65 SNT must be funded (at least in part) with the disabled client's funds when the client is under age 65, and it must be "established" by the client's parent, grandparent, guardian, or a court. The trust may continue after the client passes age 65, but it may not be funded with any of the client's assets after that age. The trust may be fully discretionary as to the client (income and principal) and, importantly, the client must be the only beneficiary during his lifetime. On the client's death the trust *must* provide that the government will then be reimbursed for the cumulative Medicaid (but not SSI) benefits paid on the client's behalf, without interest. Any trust assets remaining after the state is paid may be distributed according to the client's wishes as set forth in the trust, including, of course, his family, heirs, or other beneficiaries.

Despite the apparent good intent of Congress to provide this safe harbor trust for disabled clients who acquire assets, they missed at least one very important point. As noted, the law states that an Under 65 SNT must be established by a parent, grandparent, guardian, or court; it does not state that the client himself may establish it, or that it may be established by the client's conservator. Most commentators and some courts, however, believe the restrictions on who may establish an Under 65 SNT was an oversight and have not bound themselves by the bald statutory terms. See, e.g. In re Moretti, 606 N.Y.S. 2nd 543 (Sup. Ct. Kings County 1993) (where an Under 65 SNT established by a conservator was approved). Following this slightly expanded reading of the statute, the authors believe that an Under 65 SNT may be "established" by, say, a parent as settlor, with a transfer of the client's funds to the trust by the client's attorney-in-fact acting under a durable power of attorney. To conclude otherwise would preclude a disabled but mentally competent client who receives the settlement funds from establishing such a trust. The question remains, however, as to how a disabled but mentally competent client with no parent or grandparent could establish such a trust without being forced to go to the expense of a special court petition to do so. Accordingly, a "technical correction" to the law is clearly in order.

It is one thing to establish a trust which meets the statutory requirements to hold the settlement funds, but what about distributions from the Under 65 SNT? The attorney/advisor must be aware that poorly planned distributions can adversely affect the benefits available to the client. For example, to the extent the client receives distributions that constitute or could be used to acquire "food, clothing, or shelter", the client's SSI payments will be reduced. See Emily Starr, *Special Needs Trusts Help Preserve Public Benefits*, (Mass. Lawyers Weekly, December 3, 2001). Similarly, if an institutionalized beneficiary who is receiving Medicaid benefits receives regular cash distributions from the trust, his "patient paid amount" will be increased, thereby needlessly reducing the balance in the trust. (The "patient paid amount" is the amount of the client's income that he is required to contribute towards his care.) Thus, the trustee administering an Under 65 SNT must be very careful to secure expert advice on when and how to make discretionary distributions.

To avoid such benefit-threatening distributions, some attorneys hasten to draft the Under 65 SNT as a "supplemental needs trust", containing language that directs the trustee to provide only for the beneficiary's "supplemental" needs and expressly prohibiting the trustee from making any distributions that would be treated directly or indirectly as food, clothing, or shelter. The authors strongly disfavor such an approach as it is far too restrictive and inflexible. First, it assumes that the beneficiary will always be on SSI; second, it reflects a lack of understanding that it may actually be beneficial to make a trust distribution that causes a (temporary) reduction in the beneficiary's SSI payment (but not below zero), where, for instance, the SSI reduction is only $100 or $200 but the trust distribution is $1,000 or $2,000 (because such trust distributions do not reduce SSI dollar for dollar); and third, it assumes that the law will not change during the beneficiary's lifetime.

Now that the attorney has insured that the statutory requirements have been met and the discretionary terms of the Under 65 SNT set in place, the attorney must consider the client's tax consequences. It is important to understand that the disabled client is treated for tax purposes as the settlor of the trust even though the trust is actually created by a third party. This is so because it is the client's settlement proceeds which fund the trust, with the direct or indirect consent of the client. Since the trust is "self-settled", in Massachusetts, as in most states, a creditor of the client could reach the assets within the Under 65 SNT. <u>Outwin v. Commissioner</u>, 76 T.C. 153 (1981), *act*. 1981-2 C.B.1; Rev. Rul. 76-103. And because the trust fund is reachable by the client's creditors, federal tax laws will not treat this as a completed gift. <u>Id</u>. If, however, the interest of the client is limited, rather than fully discretionary, the transfer of sizable settlement proceeds to the irrevocable trust could produce a substantial gift tax liability, which could be somewhat disastrous for the beneficiary, if not the attorney. If trust distributions are to be limited, this potential trap is easily avoided by having the disabled client retain a special testamentary power of appointment over the principal, the presence of which would render the gift incomplete and avoid the gift tax exposure. Treas. Reg. §25.2511-2(c).

As to income taxes, since the Under 65 SNT is settled by the client for his own benefit, it is a "grantor trust", and all of the income (and losses) will pass through to the client and be reported on his individual income tax return. This is so even though he may receive no payments in a given year. I.R.C. §677. Note, however, that the tax code provides that settlement payments received by the trust generally will not be taxable income to the beneficiary under I.R.C. §104(a)(2), provided they represent damages for "personal injuries or sickness". Punitive damages and damages for emotional distress are generally taxable, as is income or gain realized on investment of all recovery funds after they are received. This rule applies whether the settlement or award is a lump sum or payable over a period of years.

Estate tax consequences can be straightforward for lump-sum settlements but pose a dangerous trap for “structured settlements,” which are generally arranged as guaranteed annuity payments for a term of years. Whether the Under 65 SNT is funded with a lump sum or a structured settlement, the trust fund will be fully includible in the estate of the disabled client because of the retained benefits, even though discretionary. I.R.C. §§2036 and 2038. With the lump sum contribution, any estate taxes due may be paid from those funds, and an estate tax deduction will be allowed for amounts paid to reimburse the state as statutorily required. I.R.C. §2053. Where a structured settlement is involved, however, and payments have not been completed by the death of the disabled client, an estate tax could be due without corresponding funds to pay it. This is because the federal estate tax laws will tax the *present value* of the future payments in the estate of the beneficiary. Treas. Reg. §20.2031-7. Note that it is possible for the attorney to plan around this problem, once aware of it, by negotiating with the defendant’s payor for a lump sum payout to the Under 65 Trust on the death of the disabled client to help cover the taxes that may be due. For a more detailed discussion of this issue see Alexander A. Bove, Jr., *Dangerous Tax Trap for Structured Settlements,* (Mass. Lawyers Weekly, August 18, 1997).

With the exception of the potential estate tax problem in a structured settlement, a properly drafted Under 65 SNT does not really pose any serious tax concerns, and aside from taxes, the only real exposure is the requirement to reimburse the state for benefits paid to the disabled client during his lifetime or for the existence of the trust. As noted, any funds remaining after that payment (and after taxes and expenses) may be distributed to the disabled client’s heirs or other desired legatees as specified in the Under 65 SNT.

Since the Under 65 SNT trust can preserve the recovery and allow the disabled client to remain on a benefits program without really giving up very much in return, wouldn’t every personal injury client who is left disabled and who otherwise qualifies for benefits be advised to consider such a trust? In many instances, it is because the attorney is not aware of the opportunity. If this is the case, is the attorney exposed to liability for failing to make the client aware of it?