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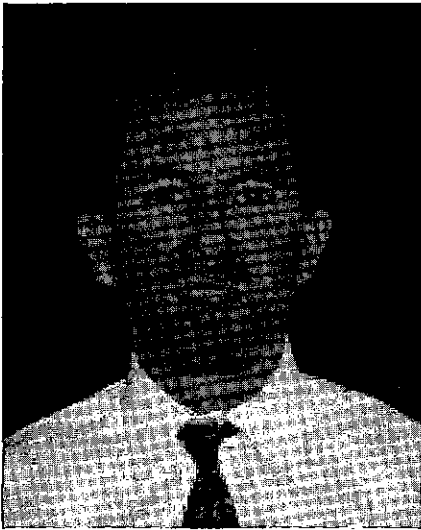
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Settlement Trusts and Medicaid Exempt Supplemental Needs Trusts - What the Georgia Plaintiff's Attorney Needs to Know

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Upon completion of the often long, grueling and expensive process of reaching a settlement for a client, the plaintiff's lawyer may believe that his job is fully done and give little thought to the consequences of handing over lump sum payment to the client. Or, as is often the case, the insurer may present an annuity as part of the settlement, which the plaintiff's attorney believes will help ensure that the client's future needs are provided for. While either of these two options may be appropriate in many cases, other situations may instead call for a third option, without which the client could incur substantial damages either in the form of loss of governmental benefits or mismanagement of funds. This third option is referred to herein generically as a Settlement Trust. Within the category of Settlement Trusts lies what is often referred to as a Medicaid exempt Supplemental Needs Trust, meaning that it is designed to supplement rather than supplant governmental needs based assistance such as Medicaid and Supplemental Security Income ("SSI").

REASONS FOR RECOMMENDING SETTLEMENT TRUSTS

Clearly, if lump sum receipt of the settlement proceeds or annuity payments would cause a client to immediately forfeit their Medicaid and/or SSI benefits, then the lawyer has a duty to inform his client of this

and advise them of the options, including methods by which the governmental assistance can be maintained. But, in cases where governmental benefits are not in the picture, what duty, if any does the lawyer have to advise the client of the Settlement Trust option as an alternative to outright lump sum payment. This is a particularly relevant question where the lawyer knows that the client is fiscally irresponsible, or where the plaintiff is a minor or adult ward and the funds would otherwise pass into guardianship.

Often, the primary purpose of suggesting a structured settlement or a Settlement Trust is to help insure that the proceeds are there to meet long term needs. All too often one hears stories of, or has seen first hand, a client who has received a large settlement intended to meet the client's long term financial needs, and who a few years later is left with nothing but debts. This wasting of assets can be blamed on many factors, but often times it is due to the fact that the client lacks experience with managing money, and/or wastes the settlement proceeds money on consumer goods having no long-term value. Based upon the knowledge that the client may very likely waste the proceeds that the lawyer has worked to provide, it is in the best interest of the client and the profession, that the lawyer fully inform and advise the client of the settlement alternatives available, the

advantages and disadvantages of each, and using the lawyer's experience in these matters, assist the client in making an appropriate decision.

In order to help the plaintiff's lawyer gain a general understanding of when to recommend a trust, this article discusses features and benefits of Settlement Trusts, including Medicaid exempt Supplemental Needs Trusts.

USE OF SETTLEMENT TRUSTS IN NON MEDICAID/SSI SITUATIONS

(a) Professional Management.

As noted above, in some cases where continued Medicaid and/or SSI eligibility is not a factor, a trust created for the benefit of the plaintiff, funded with litigation proceeds or an annuity stream may still be appropriate. Where there is concern over the client's ability to successfully manage the funds to meet the client's long term needs, a trust with a third party trustee should be considered. The third party trustee provides professional management and control over the distribution of trust funds. The trustee may also provide financial planning including helping the beneficiary with budgeting, forecasting and long term needs planning.

(b) Avoiding Georgia Guardianship.

In cases where the plaintiff is a minor or an adult ward (referred to herein collectively as a "ward"), lump sum settlement or the receipt of annuity payments will be subject to Georgia guardianship statutes. These statutes dictate a very restrictive court supervision process in order to protect the ward's property from theft or mismanagement. Where small dollar amounts are involved, a guardianship of the property may be the only viable solution. However, where the settlement funds are sufficient to economically justify and

attract a professional trustee, then a trust will usually provide a better long-term arrangement for the beneficiary. Court approval of the ward's trust will have to be obtained (see discussion below). Courts are generally receptive to the trust concept where adequate safeguards are included in the trust agreement. One of the key safeguards is the use of a professional or corporate trustee, with the financial strength to indemnify the trust. Also, under O.C.G.A. Section 53-12-174(e), corporate trustees are not required to post bond, with the benefit that this significant cost savings helps offset the corporate trustee's fees.

(c) Delaying Distribution Dates Until More Appropriate Ages.

Under the Georgia guardianship statutes, a minor is to receive their guardianship funds at age eighteen. Most parents agree that this is too young an age to receive a large amount of cash or property. By using a trust, with court approval, the age(s) of outright distribution can be extended to more appropriate ages. Commonly desired distribution ages are age thirty, at which time the beneficiary would receive one-half of the trust and age thirty-five at which time the beneficiary would receive the balance of the trust. Prior to those ages the trustee may make distributions for the beneficiary's needs as set out in the trust agreement. The goal is to extend the ages of outright distributions well beyond age eighteen, in order to protect the child from the potential negative effects of having access to excessive funds at too young of an age.

MEDICAID EXEMPT SUPPLEMENTAL NEEDS TRUSTS

A Supplemental Needs Trust (also commonly referred to as a special needs trust) is generally thought of as a trust created for someone who requires long term medical care and would otherwise be

Medicaid eligible. To be Medicaid eligible, one must be financially destitute, having only limited income and assets (referred to as resources). If the trust is treated as a resource, then it must be spent down (i.e., depleted) before the individual can become Medicaid eligible again. In the end, the client will be left in the same position as if he/she had never received the settlement proceeds. The goal of a Supplemental Needs Trust is to prevent the trust property from being treated as a resource, thus creating a nest egg for the client to be used for expenses not otherwise paid for by Medicaid. Payments from the trust could be made for additional rehabilitation and therapy, in home care (including payment to a family member), entertainment, transportation (including an automobile or van), travel costs, capital improvements to the home to facilitate the beneficiary's physical needs, and other items to make the client's life as pleasant as possible. These benefits often also indirectly benefit the family of the beneficiary.

(a) Supplemental Needs Trusts Rules Established Under OBRA 93.

Under the Omnibus Budget Reduction Act of 1993, any trust created at the direction or request of an individual will be treated as a resource of that individual for Medicaid eligibility purposes (42 U.S.C. §1396p(d)(2)(A)(iv)). Thus a Settlement Trust would be treated as a resource to the beneficiary of the trust. An exception applies if a trust is created by a parent, grandparent, guardian or a court for a disabled person (using the social security definition), under age 65, and if the state at the death of the person will be reimbursed for any medical assistance provided. These rules are codified in 42 U.S.C. §1396p(d)(4)(A) and thus another term used for the Supplemental Needs Trust is a "(d)(4)(A)" trust. Accordingly, if the

Continued on next page

(d)(4)(A) requirements are met then the trust will not be treated as an asset resource in determining Medicaid eligibility. To cause a Settlement Trust to be treated as a Medicaid exempt Supplemental Needs Trust under OBRA 93, it is therefore necessary to have either the parent/guardian or if neither of those is applicable to the case, then the court with jurisdiction over the tort case, create the trust for the benefit of the Medicaid needy client. Further, in order for the Supplemental Needs Trust to be Medicaid exempt and also to not affect SSI benefits, if applicable, the Trust must be irrevocable under state law.

(b) Repayment Obligation At Death.

As noted above, one of the requirements to be an exempt Trust is that at the beneficiary's death, any Medicaid payments made by the state subsequent to the time the trust was created must be repaid to the state. If the Medicaid reimbursement is less than the value of the trust, then the remainder will pass in accordance with the trust document, which is commonly to the heirs at law of the trust beneficiary. If the trust assets are less than the Medicaid reimbursement, then the state will get all of the trust property. Notwithstanding that after the repayment obligation to the state there might not be anything to pass to the family on the death of the Medicaid needy beneficiary, the Supplemental Needs Trust has great value as a nest egg for the beneficiary to be used to make the beneficiary's life as comfortable as possible and to provide the additional assistance that Medicaid will not pay for.

(c) Distributions From The Supplemental Needs Trust.

In addition to the asset test, state Medicaid rules provide monthly income limits, including in some cases, household limits, in order to maintain Medicaid eligibility. SSI

benefits and Social Security benefits (which are separate and distinct from the needs based SSI benefits) are counted in the income test. Under the Medicaid rules, any amounts which are paid to the trust beneficiary either in cash, which can be converted to cash, or which are for food, clothing or shelter, are counted as income when computing whether the income limits are exceeded. Thus, the Trustee must pay careful attention to the amount and type of disbursements so as not to cause the trust beneficiary to fail any of the applicable income limitations. If the trust beneficiary is also receiving SSI, then additional rules apply, which will need to be addressed if the trust beneficiary is to continue to receive SSI benefits. In other words, while the Trust may be written to comply with the (d)4(A) rules so that the trust is not treated as an asset, the trust must be administered properly on an ongoing basis so as to not violate the Medicaid income limitations.

(d) SSI Qualifications.

In 1999 congress changed the SSI income qualification rules for trusts to be similar to the Medicaid exempt trust qualification rules. As such one can now also continue SSI benefits while being the beneficiary of a trust. However, because the SSI income limits are much less than the Medicaid income limits, and because the SSI monthly benefit is relatively low (around \$500 per month) often times the Trustee may elect to waive the SSI benefits in order to be able to make larger distributions from the trust to the trust beneficiary under the more liberal Medicaid income limits.

(e) Community Trusts.

The discussion in this article has focused on a separate and single stand-alone trust, written for the beneficiary's particular needs, and which will not be treated as a resource for Medicaid eligibility purposes. As noted above, this is

what is referred to as a (d)(4)(A) trust. In addition to this exception for (d)(4)(A) trusts, a second exception applies to payments made to a "community trust" under 42 U.S.C. §1396p(d)(4)(C). To qualify, a community trust must be run by a non-profit organization, and while the funds must be pooled for investment purposes, separate accounts may be maintained for the individual beneficiaries. At death, any funds not retained by the community trust are to be repaid to the state up to the amount of Medicaid assistance provided. In Georgia, we are fortunate to have the Georgia Community Trust to serve in this function. Their web address is www.georgiacommunitytrust.com where copies of their master trust, joinder agreement, and other information can be found.

The use of a community trust to receive settlement proceeds is a viable option for Medicaid eligible clients, particularly when the settlement proceeds are small and the cost of establishing and maintaining a separate stand alone Supplemental Needs Trust cannot be justified. However, where the proceeds are sufficient to justify a separate trust, many clients will desire their own individual Supplemental Needs Trust; because it is tailored for their needs, and their funds will not then be pooled with others for investment purposes. Also, the option to replace a corporate or professional trustee is a feature of the stand alone Supplemental Needs Trust that many clients view as critical in this decision process.

ISSUES AFFECTING BOTH SETTLEMENT TRUSTS AND MEDICAID EXEMPT SUPPLEMENTAL NEEDS TRUSTS.

(a) Court Approval.

Georgia law (O.C.G.A. §29-2-16) requires court approval of the settlement of a minor's claim and to allow the settlement funds to pass to

a trust, rather than into guardianship. O.C.G.A. §29-5-4 makes O.C.G.A. §29-2-16 applicable to adult wards, thus all of the Georgia statutory provisions regarding establishing a trust for a minor or an adult ward are contained in O.C.G.A. Section 29-2-16. There one finds various rules for compromising claims and the annuity and trust approval process. The required process depends on the status of the case and dollar amounts involved.

(b) Tax Returns And Grantor Trust Income Tax Status.

The trust will likely be required to file a federal and state income tax return. In most cases, having the trust treated as a "grantor trust" under IRC §671, et. seq. will be the best strategy. Trusts that pay their own tax are presently disfavored under the federal tax brackets, as a trust enters the 38.6% tax bracket at \$9,200 (rates for 2002) of taxable income, versus a single individual who does not reach that bracket until \$307,050 of income. As a grantor trust, the trust is effectively ignored for income tax purposes and the trust income is reported on the beneficiary's individual income tax return (IRS Form 1040). Not only is a lower tax rate used, but also by reporting the trust income on the individual's 1040, his/her personal exemption and itemized deductions, including medical expenses, can be used to offset the trust's taxable income. One way to create grantor trust income tax treatment is to give the plaintiff/beneficiary a right to substitute trust property with property of equal value pursuant to IRC §675.

(c) Avoiding Designated Settlement Fund Tax Status (IRC Section 468B).

An income tax trap under IRC §468B arises in situations where the defendant makes a settlement payment directly to the trustee of any Settlement Trust, including a

Medicaid exempt Supplemental Needs Trust. Under that code section, if a defendant makes a payment to a trust to settle a tort claim, then unless the trust qualifies as a Designated Settlement Fund (or Qualified Settlement Fund under Treasury Regulation §1.468B-1), the defendant is not entitled to a tax deduction for its payment. The problem with being taxed as either a Designated Settlement Fund or Qualified Settlement Fund is that the trust will be taxed on its income at the highest corporate income tax rate, and the trust's deductions are very limited. If instead the trust is taxed as a grantor trust (see discussion above) then a lower tax will generally result since the beneficiary's tax rate will likely be lower than the highest corporate tax rate and the beneficiary can also deduct itemized deductions, including medical expenses, against trust income. To avoid the harsh tax treatment under IRC §468B one should have the defendant's payment made to the client and deposited in the plaintiff's attorney's trust account. Then upon either direction from the client or the court, as applicable, the plaintiff's attorney would make disbursement from their law firm trust account to the Settlement Trust, after having paid expenses and attorneys fees. By this method, the defendant has not made a payment to a trust.

(d) Annuity Owned By A Settlement Trust.

Where it is determined that an annuity is an appropriate investment choice as either representing the entire settlement benefit to the client, or in part also with a lump sum cash payment, the trust can own and be the beneficiary of the annuity payments and still enjoy the tax free nature of the payments under IRC §104 and 130 (assuming that the trust is a grantor trust as described above). If the Settlement Trust is also designed as a Medicaid exempt Supplemental Needs Trust, then by

having the annuity owned by the trust, rather than the client, the present value of the annuity will not be counted as a resource and the annuity benefits when paid to the trust will not be treated as income to the trust beneficiary. Further, if the annuity payments are in excess of the client's immediate needs, then the trustee may retain the excess payments in trust for future needs.

(e) Clause Allowing The Removal Of A Professional/Corporate Trustee.

Where a professional or corporate trustee is named, one should consider including in the trust agreement the power to remove and replace the trustee with an equally qualified trustee. This allows the client some flexibility to change professional trustees if they desire such a change. If there are concerns over the client's ability to properly exercise this discretion, an advisory committee or "trust protector" can be named in the trust agreement to serve in this role. Typical members of this committee would be the client, the attorney, and a trusted friend of the client or family member. By including this removal power, the beneficiary may become more comfortable with the use of a trust knowing that if the trustee fails to provide good service then the trustee can be replaced.

CONCLUSION

The use of a trust to receive settlement proceeds can provide many benefits to a client, including protecting Medicaid and SSI benefits, avoiding guardianship for minors or adult wards, and providing financial management for the long-term needs of the client. Whether all of these benefits are relevant is dependent on the client's situation; however, by advising the client of their options, the plaintiff's lawyer provides a better service to the client. ■