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Pooled Trusts: An Introduction and Personal History

Thomas E. Simmons

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AN INTRODUCTION AND PERSONAL HISTORY

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This paper was presented at the NAELA SPECIAL NEEDS SUMMIT in New Orleans, Louisiana in 2010.

I. INTRODUCTION

II. (or "d4Cs Rock!")

A "pooled trust" -- or a (d)(4)(C) trust -- is unique in several ways. (a) A pooled trust is not restricted to individuals under age 65 (although this is under challenge in certain states); (b) A pooled trust can be established by the individual himself/herself; and (c) The at-death "payback" requirement to satisfy the Medicaid lien at a beneficiary's death is stated differently than the payback requirement of a (d)(4)(A) (or "payback") trust. Trusts in other states other than my own state of South Dakota have been established to qualify for the special pooled trust benefits.[1] In 2003, I personally undertook to found a nonprofit entity to manage the trust and to draft the first pooled trust in South Dakota. Once the trust was established, but prior to its first beneficiary being added, I commenced a declaratory action on behalf of the nonprofit entity in order to receive judicial clarification that the trust would actually be respected by the South

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[1] Other pooled trusts include, notably:
~ The ARC of Texas Trust. www.thearcoftexas.org/programs/masterpooledtrust/
~ The North Dakota Pooled Trust. www.gapsinc.org/ndtrust.htm
~ The Commonwealth Community Trust of Virginia. www.commonwealthcommunitytrust.org
~ The Community Fund Management Foundation of Ohio. www.cfmf.org/interior/trusts.html
~ The Alpert Jewish Family & Children's Service, Inc. of Florida. www.jfcspb.org
~ The Georgia Community Trust. www.georgiacommunitytrust.com
~ The Maine Pooled Disability Trust. www.mainepooleddisabilitytrust.com
~ The Evergreen Presbyterian Ministries Trust of Louisiana. www.epmi.org/howtohelp-trust.aspx
See also generally, www.specialneedsanswers.com/resources/director_of_pooled_trusts.asp (providing a director of pooled trusts).

The South Dakota Guardianship Program in Pierre, South Dakota has administered a trust which pools investments for its disabled beneficiaries since 1997, the South Dakota Guardianship Program Trust (SDGPT). This trust is generally utilized by parents to establish low-cost trusts for disabled child. The minimum investment in the trust is $5,000. In the author's experience, the SDGPT does an excellent job and provides an important service for its beneficiaries.

Dakota Department of Social Services (herein, the "Department"). Eventually, our Circuit Court did confirm the effectiveness of the trust, requiring a few modifications to conform to state and federal law. The court restated and amended the trust to meet these requirements. But the Department has recently departed from the order entered in the declaratory action and started treating trust contributions by beneficiaries age 65 and older as divestments which incur an eligibility penalty.

Perhaps the single greatest benefit to the Pooled Advocate Trust is its ready-made availability to disabled persons. (The same could be said of any pooled trust.) There is no need to draft a qualifying Medicaid trust from whole cloth; the trust is already drafted and a applicant/beneficiary need only complete the joinder agreement and submit it for review and approval to the trustee and nonprofit overseer. With the Pooled Advocate Trust, there is also no minimum trust contribution, the application fee is only $100, and the trustee charges reduced trustee fees.[2] Thus, the trust has proven popular especially with disabled persons of limited means, which is probably just what Congress intended when it enacted the pooled trust rules in 1993.[3]

The South Dakota Pooled Advocate Trust was the first of its kind in South Dakota and probably the first of its kind in the entire country insofar as the "asset protection" provisions it features. Assets contributed to the trust by a disabled person are – subject to certain limited exceptions – exempt from that person's creditors because the trust qualifies as a "domestic asset protection trust" (DAPT). This can be a great benefit to disabled persons who may be vulnerable to predatory credit card offers or overzealous plaintiffs who want to pursue the deep pockets of a disabled individual.

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[2] *See* www.pooledadvocatetrustinc.com (website no longer online).

[3] Pub. Law 103-66 § 13611 ("OBRA '93").

An additional advantage and unique aspect of South Dakota's pooled trust is the inclusion of a "trust advocate" role. The trust advocate is an individual whose role is to assist the trustee in identifying needs of the beneficiary, and advocating for the beneficiary's best interests. This allows family members to continue to be involved in the administration of the trust, without taking away ultimate responsibility of investments, distributions and accountings.

II. PERSONAL HISTORY

(or "How I Created South Dakota's First Pooled Trust and Nearly Lost My Mind")

In the fall of 2003, I had been practicing law for three years and was a member of a firm with little or no elder law practice. I was engaging in the process of teaching myself the rules of Medicaid eligibility. I was poring over the dense federal statutes discussing the treatment of certain types of trusts in connection with Medicaid eligibility criteria. Generally speaking, an individual cannot create a trust for themselves and then qualify for Medicaid, although there are limited exceptions, and I was focused on understanding those exceptions. An internal light bulb went off as I read 42 U.S.C. 1396p(d)(4). "That's it!" I thought, "That's what we need for disabled South Dakotans with funds of their own." This kind of a trust is called a "pooled trust" or a (d)(4)(C) trust.

Trusts in other states had already been established to qualify for the special pooled trust benefits.[4] After reviewing the various pooled trusts established in sister states, I undertook to draft a trust for South Dakota residents with disabilities and form a 501(c)(3) entity to establish, manage, and oversee the trust. The nonprofit was created with my own resources and funds and it was named "Pooled Advocate Trust, Inc." or, conveniently, "PATI." A local corporate trust

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[4] *See supra.*

fiduciary, Great Western Bank, agreed to serve as Trustee, and bookkeeping and accounting specialists were identified.

Once the trust was established, but prior to its first beneficiary being added, I commenced a declaratory action in order to receive judicial clarification that the trust would actually be respected by the Department (which administers the Medicaid program in South Dakota). The Declaratory action was filed on November 22, 2004. The Department was served with the complaint seeking declaratory relief. We asked the Court to enter an order confirming that the Trust qualified as a pooled trust under applicable law and that "transfers of a beneficiary's or of a beneficiary's spouse's assets or property to the trustee of the Trust shall not constitute a disqualifying "transfer" or "Disposal of assets" for purposes of Medicaid eligibility." The trust, as proposed, did not contain any age limitation. The Department filed an Answer. The Department raised a lack of ripeness as one defense (since there was then no actual trust beneficiaries, but later withdrew this defense).

When the trust was initially drafted, the proposed "payback" provision provided that upon a beneficiary's death any remaining funds in the beneficiary's sub-account would be deemed "Surplus Trust Property" and used, in the Trustee's discretion, as follows:

1. For the benefit of other Beneficiaries of the Trust by funding other Trust Sub Accounts of the Trust on a pro rata or other basis;

2. To add indigent disabled individuals . . . to the Trust as Beneficiaries;

3. To provide indigent disabled individuals . . . with equipment, medication, or services;

4. To contribute principal or income (or both) to the PATI (Pooled Advocate Trust, Incorporated) Donor Advised Fund with the South Dakota Community Foundation[5]; or

[5] The Donor Advised Fund instructed the community foundation as follows: Distributable income shall be used to provide financial support to:

5. Any combination thereof.

Any trust property not treated as Surplus Trust Property had to be applied towards satisfaction of the Department's Medicaid lien, with any excess being distributed to the beneficiary's heirs identified in his or her joinder agreement.

The Department focused its objections on the way in which the payback provision read, especially with regards to the ability of the Trustee to make distributions to the Donor Advised Fund. Following discussions with the Department, by Stipulation, the Department and I agreed to file cross motions for partial summary judgment on the issue of the payback provision in the trust. The matter was fully briefed by both parties. The Department argued, "Labeling assets 'retained' is not sufficient to meet the requirements of the rules." The Department's most strenuous argument was that distributing to charity for the benefit of disabled persons was a distribution and would therefore trigger the payback requirement. By Memorandum Opinion dated September 28, 2005, our Circuit Court agreed and concluded that as drafted, the at-death Medicaid reimbursement provisions of the Trust (which proposed a charitable donation of any assets retained by the trust) were indeed inconsistent with state and federal law.

The Court stated:

> While Medicaid must be reimbursed before funds are placed in the sub-account for the South Dakota Foundation, the Court determines that the funds may be kept in the pooled trust and distributed to the accounts of the other trust beneficiaries without first reimbursing Medicaid. First and most importantly, under that scenario, the trust would retain control over those funds; those funds would not be "distributed from" the trust. Secondly, the money would eventually be distributed to individual identified primary beneficiaries of the trust through accounts set up

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One (1) or more agencies, corporations, associations and/or churches which advance the interests of individuals with disabilities including children, adults and senior citizens with disabilities in the State of South Dakota as determined by the Foundation's Board of Directors.

> for those beneficiaries. . . . Accordingly, the retention of the funds in the trust for the other beneficiaries would satisfy the pertinent requirements . . .[6]

We then moved the Court for an order directing the Trust to be reformed so as to conform to the Court's opinion and order. The reformed payback provision of the Pooled Advocate Trust read:

> A. Surplus Trust Property Retained By Trust Surplus Trust Property which is retained by the Trust following the termination of a Trust Sub Account and following the payment of costs and expenses . . . will be distributed in equal shares to the other Trust Sub Accounts of the Trust for the benefit of the beneficiaries thereof. . . .
>
> (2) Definition of Surplus Trust Property *Not* Retained by Trust. In the event and to the extent that Surplus Trust Property is utilized by the Trustee or distributed by the Trustee to any other person or in any other fashion except as expressly set forth in section (A), such Surplus Trust Property shall be considered to have not been retained by the Trust.
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> C. Surplus Trust Property *Not* Retained by Trust Paid to DSS. If and to the extent that Surplus Trust Property is not retained by the Trust, the Trustee shall . . . before any distribution to any individual or heir is made from the Trust, pay from such Surplus Trust Property of the Trust Sub Account, an amount to the South Dakota Department of Social Services ("DSS") which is equal to the total amount of medical assistance paid on behalf of the Beneficiary under the South Dakota plan pursuant to 42 U.S.C. § 1396p for which DSS (or any entity of like character situated in another state or territory in which the Beneficiary received medical assistance, calculated proportionately) claims a lien enforceable under state or federal law. . .
>
> (1) Surplus Trust Property Not Retained by Trust After Paying DSS. Any amounts remaining after payment to DSS pursuant to the foregoing sentence shall be distributed pursuant to the terms of the Joinder Agreement.[7]

On Halloween Day, 2005, our Court entered an Order reforming the Trust with the new payback provisions set forth above. Following the entry of that Order, I moved for summary

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[6] Memorandum Opinion, Findings of Fact, and Conclusions of Law dated September 28, 2005 at 6 (Civ. No. Tru. 04-240, Seventh Judicial Circuit, South Dakota) (Davis, J.).

[7] The "Grantor" is the individual applicant. The Grantor may be the beneficiary or someone acting on the beneficiary's behalf.

judgment on the remaining issues raised by its Complaint. The Department and I entered into a Stipulation agreeing that said motion could be granted without further notice or hearing. The Court therefore granted summary judgment on the remaining issues in our favor and ordered: "the trust, as reformed . . . complies with the law, that transfers to the trust will not be penalized for Medicaid eligibility purposes so long as a beneficiary meets the requirements set forth in the Trust as reformed, and that amounts in a Trust Sub-Account will not be considered available resources for Medicaid eligibility purposes."

Thus, on account of the "modified payback" provision, at death, some beneficiaries' sub-accounts will be applied to satisfy that beneficiary's Medicaid lien, with the excess going to the beneficiary's heirs, while other beneficiaries' sub-accounts which amount to less than the Medicaid lien, will be allocated to other beneficiaries' sub-accounts. Accordingly, beneficiaries of the trust stand to potentially have their sub-account receive additional funding when another beneficiary passes away whose Medicaid lien exceeds his/her sub-account with that sub-account re-distributed among other trust beneficiaries' sub-accounts. The "modified payback" provision of the trust provides that when a beneficiary dies, all amounts remaining in that beneficiary's individual sub-account will only be utilized to reimburse the state Medicaid program for funds advanced to the extent that those amounts are not "retained by the trust."[8] This requirement, as our Circuit Court interpreted it, means that funds can either be re-distributed among other beneficiaries of the trust, or distributed to the beneficiary's heirs, but before any distributions to heirs can occur, the state Medicaid program must first be reimbursed. As a practical matter, this requirement means that when a beneficiary dies, if the amount owing to the state for Medicaid

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[8] By contrast, a (d)(4)(A) trust – the alternative self-funded Medicaid trust option – must contain a mandatory payback provision. "[T]he State will receive all amounts remaining in the trust upon the death of such individual up to an amount equal to the total medical assistance paid…" 42 U.S.C. § 1396p(d)(4)(A).

benefits received exceeds the amount in the beneficiary's sub-account, the funds will be retained by the trust and allocated among the other current trust beneficiaries. On the other hand, if the Medicaid lien is less than the amount in the deceased beneficiary's sub-account, the trustee has the flexibility of satisfying the Medicaid lien, then distributing the rest to the beneficiary's heirs. A beneficiary's heirs are identified within the joinder agreement/application.

In late 2008, a trust beneficiary had difficulty in retaining Supplemental Security Income (SSI) benefits upon the Social Security Administration's independent review of the trust instrument. The Social Security Administration (SSA) was troubled provisions in the trust which (a) allowed the Trustee to terminate a sub-account in the event that public benefits were no longer available for a beneficiary, and to suspend a sub-account if it reached a balance of one thousand dollars or less. In early 2009, the Pooled Advocate Trust was therefore reformed a second time in order to (a) make certain typographical clarifications to the Trust; and (b) to conform to requirements requested by SSA (which was not a party to the original action). The Department did not resist or object to this second reformation. An Order re: Second Reformation of Trust was entered on February 2, 2009. SSA then granted the SSI recipient eligibility; we had "cured" the problem as far as SSA was concerned through the court-ordered trust reformation process.

On November 9, 2009, I was informed via email from the Department that "the Department has determined that transfers to a pooled trust by an individual age 65 or older will be treated as a transfer for less than fair market value for Medicaid eligibility purposes." On the same day, I also learned that a recently added trust beneficiary had been denied eligibility for long term care Medicaid benefits, characterizing the beneficiary's three contributions to the trustee as disqualifying transfers for eligibility purposes. The next morning, we filed a petition

for further relief within the declaratory action asking the Circuit Court to rule that the Department was barred from advancing an age limitation requirement for the Trust's beneficiaries on account of the doctrine of *res judicata*. In the alternative, we argued, the age-based eligibility argument is not supported by applicable law.[9] The Court set a status hearing for December 14. The administrative hearing for the denied beneficiary was scheduled for December 17. As of the date these materials were submitted to NAELA, the Department had not filed a response to our petition.

Since achieving success with the original declaratory action, a total of eighteen beneficiaries have applied to and been accepted by PATI and the Trustee. One beneficiary has died, and, because the beneficiary's sub-account was less than the Medicaid lien, the sub-account was distributed equally among the other sub-accounts and the Medicaid lien was not discharged. There are currently seventeen trust beneficiaries and the market value of the entire pooled account is over $1.6 million. The trustee fee savings on an annual basis by virtue of pooling the accounts is approximately $14,000.

The asset protection features of the Pooled Advocate Trust are discussed below within a larger discussion concerning the importance of asset protection planning and spendthrift protections for trust beneficiaries – especially disabled trust beneficiaries. An additional advantage and unique aspect of South Dakota's Pooled Advocate Trust is the inclusion of a "trust advocate" role.[10] The trust advocate is an individual who's role is to assist the trustee in

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[9] *See infra.*

[10] *See* SDCL § 55-1B-6(10). "The powers and discretions of a trust protector shall be as provided in the governing instrument . . . [and] may include . . . advise the trustee on matters concerning a beneficiary." Many states have similar statutes and arguably even without express statutory authority there is room to create the role of a trust advocate or trust advisor under the common law.

identifying needs of the beneficiary, and advocating for the beneficiary's best interests. This allows family members to continue to be involved in the administration of the trust, without taking away ultimate responsibility of investments, distributions and accountings from the trustee. The pooled advocate trust has no minimum funding requirements, a flat $100 initial application fee, and very competitive trustee fees. There is also no maximum amount which can be contributed to the Pooled Advocate Trust.

III. OVERVIEW OF POOLED TRUSTS

(or "Let's Look at the Forest and the Trees")

It is helpful to examine the contours of pooled trusts within a larger context of Medicaid eligibility rules generally, and the program's rules regarding trusts as well. The basic federal safety net program for elderly, blind and disabled persons is SSI. SSA administers the program and eligibility is based upon financial need. The basic eligible criteria are that an individual have less than two thousand dollars ($2,000) in assets, or three thousand dollars ($3,000) for a couple, although certain limited resources are excluded. There are also SSI income limitations.

SSI's sister in welfare benefits is the Medicaid (Title 19) program. While SSI is entirely a federal program, Medicaid, which shares the same basic eligibility requirements[11], is a program governed by both federal and state statutes and regulations. Medicaid provides for payment of medical expenses including long term care costs which are not covered by Medicare (with certain limited exceptions) or most private health insurance.

Eligibility for Medicaid, being a needs-based benefit, depends on at least three primary criteria: (1) the individual applicant's resources; (2) the individual's income; and (3) whether the

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[11] *See also* Bridget O'Brien Swartz and Angela E. Canellos, *The Wrongful Disregard of SSI Comparability by Some State Medicaid Agencies as it Relates to SNTs*, 5 NAELA J. 2 at 139-58 (2009).

individual has made any gifts or transfers within certain time periods which result in a period of ineligibility for benefits. The resources, income and gifts attributable to the applicant's spouse are also considered. (Other eligibility criteria include state residence and the qualification of the applicant as aged, blind or disabled.)

Individual eligibility determinations for Medicaid include an analysis of any trusts to which the individual is a beneficiary. There are two basic kinds of trusts which fall under two different analytical rubrics for eligibility purposes, self-settled trusts (trusts which the individual or the individual's spouse has funded) and third party trusts (trusts funded by a third party).

a. Third Party Special Needs Trusts

Creating a trust for another person is much easier than creating a trust for oneself or one's spouse insofar as Medicaid eligibility is an objective. The reason is that self-settled trusts do not generally result in Medicaid eligibility benefits. Even when a self-settled trust is irrevocable, "and contains any provisions under which payment from the trust may be made to or for the benefit of the individual, *the entire portion* of the principal or income on the principal from which payment to the individual *could* be made is considered a resource . . ."[12] For example, a strict reading of this rule would result in the entire trust corpus being deemed an available resource for the beneficiary if the trustee had the power to distribute discretionary amounts of trust principal to the beneficiary only when (and if) the Cubs win the World Series.

Third-party special needs trusts, by contrast, are not considered an available resource to an individual applying for Medicaid so long as (1) the beneficiary has no power to compel distributions; (2) the assets in the trust can only be used for the beneficiary's supplemental needs

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[12] A.R.S.D. 67:6:05:32:02 (emphasis supplied). A self-settled trust is defined at A.R.S.D. 67:46:05:32:01 and includes trusts created by an individual's spouse (although testamentary trusts are excluded).

and not for support; (3) the trust has one lifetime beneficiary; and (4) the trust is irrevocable as to the beneficiary or the beneficiary's spouse.[13] Generally, the trustee of a third-party special needs trust will be governed by a distribution standard such as the following:

> This Trust is for the sole benefit of the Beneficiary. Distributions may be made for the Beneficiary's supplemental needs only. No part of a principal or income of this Trust may be distributed so as to replace any public assistance benefits for which the Beneficiary may be eligible. Distributions for the benefit of the Beneficiary shall be limited so that the Beneficiary is not disqualified from receiving public benefits to which the Beneficiary would otherwise be entitled. If the Trustee should expend or distribute from the Trust property, such expenditure shall only be made on behalf of the Beneficiary over and above those benefits and resources paid for by or available from the Department of Social Services of the State of South Dakota, and/or other local, county, state, tribal, or federal agency or department, including those benefits and resources which are currently available or in the future may become available. The Grantor urges the Trustee to, in the exercise of the Trustee's unfettered discretion, and consistent with the intent of the Trust, to make distributions which will permit the Beneficiary's dignity and grace, enhance the Beneficiary's day to day existence, and allow said Beneficiary the highest possible development of the Beneficiary's abilities. All distributions are vested in the Trustee's sole, absolute, and unfettered discretion. The Trustee may, consistent with the terms hereof, not make any distributions to the Beneficiary if the Trustee deems such to be in the Beneficiary's best interests. The Trustee's sole and independent judgment, rather than any other person's determination, is intended to be the criterion by which distributions for the Beneficiary's benefit are made. No court or any other person should substitute its or their judgment for the discretionary decision or decisions made by the Trustee with regards to distributions for the benefit of the Beneficiary. This is not a support trust, it is for the Beneficiary's supplemental care needs only.[14]

Third party special needs trusts need not contain any "payback" provision to the State Medicaid Agency. The Grantor of the Trust may provide that upon the Beneficiary's death, any remaining trust assets are to be distributed to other family members, charities, or the Grantor himself/herself.

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[13] Clifton B. Kruse, *Third Party and Self-Created Trusts: Planning for the Elderly and Disabled Client* at 37-43 (ABA 2nd ed. 1998).

[14] *See* Craig C. Reaves, *Which Trust Distribution Standard to Use When Drafting a Trust for a Person Who Has a Disability*, 20 NAELA NEWS 3 at 12 (2008).

b. First Party Special Needs Trusts

Whenever a trust is created by the individual Medicaid applicant, or the applicant's spouse, a quite different set or rules applies.[15] Any "first party" or "self-settled" trust is subject to two different sets of rules, depending on whether the trust is revocable (such as a living trust) or irrevocable.[16]

If the trust is revocable, then the principal of the trust is considered an available resource to the Medicaid applicant. Any payments from the trust to or for the benefit of the individual are considered income (and may disqualify the individual from Medicaid based upon the monthly income limitations). Furthermore, any other payments made from the trust (other than trustee fees or legal expenses) are deemed to be gifts which may result in a penalty period for Medicaid eligibility.[17] In other words, a revocable trust established by an individual who is applying for Medicaid is inherently disadvantageous and arguably even worse than no trust at all.

On the other hand, if a self-settled trust is irrevocable, then the following analysis applies:

> If the trust . . . contains any provisions under which payment from the trust may be made to or for the benefit of the individual, the entire portion of the principal or income on the principal from which payment to the individual could be made is considered a resource. . .[18]

Payments of income are considered income and any other payments made from the trust (other than trustee fees or legal expenses) are deemed to be gifts with potentially disqualifying

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[15] A.R.S.D. 67:46:05:32:01.

[16] A.R.S.D. 67:46:05:32:02.

[17] *Id.*

[18] A.R.S.D. 67:46:05:32:02; *see also infra.*

consequences.[19] One additional rule applies to irrevocable trusts established by Medicaid applicants or their spouses: The Medicaid Agency generally considers any part of the trust from which payments to the individual cannot be made to have been transferred to the trust for purposes of establishing Medicaid eligibility, thereby triggering a period of ineligibility.[20]

In view of these rules, self-settled trusts, whether revocable or irrevocable, which permit any distributions whatsoever for the benefit of the Medicaid applicant do nothing to advance the eligibility of the individual for Medicaid benefits. However, there are three very specific exceptions to these self-settled trust rules.

i. Medicaid Income Trusts

A Medicaid Income Trust (also known as a "Miller Trust" or "Income Assignment Trust") has limited applicability unless the individual meets the resource eligibility requirements for Medicaid assistance, since it can only be composed of the beneficiary's own pension, social security or other income.[21] Medicaid Income Trusts are not exempt trusts for SSI eligibility purposes.[22] In South Dakota, the Department of Social Services actually "hands out" Medicaid Income Trust documents to Medicaid applicants.

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[19] *Id.*

[20] *Id.*

[21] 42 U.S.C. § 1396p(d)(4)(B).

[22] John J. Campbell, *Preserving Public Benefits in Personal Injury Settlements: Special-Needs Trusts and Beyond*, 2 NAELA J. 367, 370 (2006).

ii. Under-65 Payback Trusts

An "Under-65 Payback Trust" is an irrevocable trust which meets the following requirements:

(1) The beneficiary must be disabled[23] and under age 65[24];

(2) The trust must be established by a parent, grandparent, guardian or a court (i.e., it cannot be established, ironically perhaps, by the beneficiary himself or herself); and

(3) The trust must provide that upon the beneficiary's death and before any other distribution is made from the trust, the Medicaid Agency is reimbursed up to the total amount of Medicaid benefits advanced during the beneficiary's lifetime.[25]

This type of trust is often referred to as a "(d)(4)(A) Trust" because it is described at that particular subsection with 42 U.S.C. § 1396p. It is also commonly referred to as a "Payback Trust" on account of the mandatory "payback" to the State Medicaid Agency to the extent of any Medicaid lien, upon the beneficiary's death. A d4A payback trust requires that when the beneficiary dies, all amounts remaining in the trust will be paid to the individual's state of residence up to an amount equal to the total Medicaid benefits paid during his or her lifetime. The trustee may be an individual or a corporate fiduciary. A payback trust cannot be established for individuals over age 65.

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[23] The definition of "disabled" is found within the Social Security Act. 42 U.S.C. § 1382(a)(3).

[24] The trust, if created and funded prior to the beneficiary's 65th birthday, can continue for the beneficiary's benefit after the 65th birthday, but no additional contributions can be made to a payback trust after the beneficiary attains age 65.

[25] 42 U.S.C. § 1396p(d)(4)(A). Payment of taxes and reasonable administrative expenses associated with the termination of the trust may be made but payment of debts to third parties or of funeral expenses are not allowed.

iii. Pooled Trusts

A "Pooled Trust" is an irrevocable trust which meets the following requirements:

(1) The beneficiary must be disabled[26];

(2) The trust must be established by a parent, grandparent, guardian, the court, *or* the individual himself/herself;

(3) The trust must provide that upon the beneficiary's death and before any other distribution is made from the trust, the Department of Social Services is reimbursed upon to the total amount of Medicaid benefits advanced during the beneficiary's lifetime *unless* assets are "retained by the trust"[27];

(4) The trust must be established and managed by a nonprofit association; and

(5) The trust must maintain sub-accounts for each individual but may pool the accounts for investment purposes.[28]

This type of trust is sometimes referred to as a "(d)(4)(C) Trust."

The Pooled Advocate Trust with which I am familiar and which was discussed in some detail above, is my state's first qualifying pooled trust. Although a pooled trust has additional requirements (i.e., pooled investments and a nonprofit manager), it offers greater flexibility in terms of a modified payback requirement and the ability of the individual themselves to fund the trust, as has been the case with most of our disabled but competent beneficiaries. A d4C pooled trust must be managed by a nonprofit association which pools investments, but maintains separate accounts for each beneficiary. When a beneficiary of a pooled trust dies, the trust need

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[26] *See supra.*

[27] The "retained by the trust" language has been interpreted to mean that assets in a sub-account may be re-distributed among other beneficiaries of the trust in order to avoid the "payback" requirement. If the trust assets exceed the amount owing to the Department of Social Services, the Department can be repaid with the remainder distributed to individually named heirs or charities.

[28] 42 U.S.C. § 1396p(d)(4)(C).

only "pay back" the state Medicaid program to the extent that amounts are not "retained by the trust." Various interpretations have been advanced as to what the "retained by the trust" requirement for pooled trusts means. Some trusts retain amounts for the benefit of other surviving trust beneficiaries while others utilize funds to benefit nonprofit or charitable agencies.

Probably the greatest benefit to the Pooled Advocate Trust – or any pooled trust – is its ready-made availability. The trust is "pre-drafted." There is no need for an attorney to draft a trust. All that needs to occur is to complete the joinder agreement and submit it for review and approval by the Trustee and PATI. Attorney fees are therefore minimized. Trustee fees are also minimized because of the pooled nature of the investments.

Thus, assuming that the beneficiary otherwise qualifies for Medicaid (i.e., owns less than $2,000 in countable assets for a single person), he or she will preserve the assets in the trust, while continuing to qualify for Medicaid. There is no lien which accrues for other needs-based benefits the beneficiary may also qualify, such as SSI and Section 8 Housing. Moreover, benefits provided at the Medicaid rate are generally at a significantly less cost than individual on "private pay" would be charged in a long term care facility, and the Medicaid lien itself does not accrue interest.[29]

Self-settled trusts which do not qualify as d4 trusts do not advance Medicaid eligibility. In fact, transfers to a non-d4 self-settled trust can result in the imposition of a penalty period during which Medicaid eligibility is denied or suspended, even if the applicant otherwise qualifies. The draconian trust rules and very limited and specific exceptions may be softened in certain circumstances "if the individual can clearly show that all efforts have been made to

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[29] One example of the Medicaid/private pay rate differential from a Western South Dakota nursing home is $117.02/day versus $156/day, an annual savings of over $14,000.

recover assets placed into the trust and the individual's continuing care or well-being is seriously threatened because of the ineligibility for long-term care assistance."[30] This "undue hardship" exception puts the burden on the Medicaid applicant and often is of limited utility.

IV. THE OVER-64 ARGUMENT

(or "Why We're Right")

In recent years, State Medicaid Agencies have begun to argue that contributions to a pooled trust can be penalized as divestments or gifts, with resultant eligibility penalties for Medicaid benefits.[31] Essentially, the States have taken the position that transferring assets to a pooled trust should be treated the same as a Medicaid applicant's gift of assets to their children within the five year "look back" window. There does not appear to be any argument that assets, once transferred to a pooled trust, are an unavailable resource for eligibility purposes regardless of the grantor's age at the time of the transfer. Clearly, the language at 1396p(d)(4) includes a restriction of (d)(4)(A) trusts based on age: the grantor must be under age 65 at the time of the transfer to the trust. But plainly there is no such age requirement in the language descriving a (d)(4)(C) trust. Some states have argued, however, that although amounts contributed to a (d)(4)(C) pooled trust will be deemed unavailable resources to an over-64 grantor, the contribution itself is a "divestment" or gift for less than fair market value, triggering a penalty

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[30] A.R.S.D. 67:46:05:32:04.

[31] *See* Sara Buscher, *States Attack Pooled Trusts for Persons Who are 65 and Older*, 20 NAELA NEWS 3 at 17 (2008).

period of ineligibility if application for Medicaid benefits is made within the five year "look back" period.[32]

Essentially, the basis for the states' argument is found in the awkward drafting of certain aspects of section 1396p, specifically 1396p(c) (which governs generally the penalties for divestments or gifts) and 1396p(d) (which describes (d)(4) trusts). A careful analysis, however, reveals that the states' position is misplaced.

The general divestment rules of 1396p(c) state:

> (1) [T]he State plan must provide that if [a] . . . person disposes of assets for less than fair market value on or after the look-back date . . . the individual is ineligible for medical assistance . . . during the period beginning on the date specified in subparagraph (D) and equal to the number of months specified in subparagraph (E).
>
> (2) An individual shall *not* be ineligible for medical assistance by reason of paragraph (1) to the extent that -- . . . the assets were transferred to, or to a trust [sic] (including a trust described in subsection (d)(4) of this section) established solely for the benefit of an individual under 65 years of age who is disabled (as defined in section 1382c(a)(3) of this title.[33]

Subsection (2) does indeed suggest, on first reading and if read in isolation, that the exception for penalty periods being assessed for transfers to (d)(4) trusts is dependent on the individual being under 65 years of age. Stated another way, subsection (2) seems to say that the exception for assessing penalty periods for transfers to trusts is contingent upon the grantor being under 65 years of age. But subsection (2) is referring to transfers to trusts for the benefit of persons other than the grantor,[34] not pooled trusts for the benefit of the grantor him or herself.

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[32] Many thanks and credit are due to attorney Sara Buscher in providing the author with invaluable and voluminous research and carefully constructed analysis and argument on the states' attacks on pooled trusts, much or most or which formed and shaped this section.
[33] 42 U.S.C. § 1396p(c)(1), (2)(iv) (emphasis supplied).

[34] *See* H.R. Rep. 103-111, 103rd Cong. 1st Sess., at 207-08 reprinted in 1993 U.S.C.C.A.N. at 534-35 ("With respect to irrevocable trusts which cannot in any way benefit the grantor, the

The specific rules regarding trusts at subsection (d) of 1396p state:

(1) For purposes of determining an individual's eligibility for . . . benefits . . ., subject to paragraph (4), the rules specified in paragraph (3) shall apply to a trust established by such individual.

(2) For purposes of this subsection, an individual shall be considered to have established a trust if assets of the individual were used to form all or part of the corpus of the trust [and if the individual or individual's spouse] established such trust.

(3)(A) In the case of a revocable trust – the corpus of the trust shall be considered resources available to the individual . . .

(B) In the case of an irrevocable trust –

(i) if there are any circumstances under which payment from the trust could be made to of for the benefit of the individual the portion of the corpus which . . . payment to the individual could be made shall be considered resources available to the individual, and payments . . .

(I) to or for the benefit of the individual, shall be considered income of the individual, and

(II) for any other purpose, shall be considered a transfer of assets by the individual subject to subsection (c); and

(i) any portion of the trust from which . . . no payment could be made . . . to the individual . . . shall be considered . . . to have been assets disposed by the individual for purposes of subsection (c) of this section . . .

(4) This subsection shall not apply to any of the following trusts:

(A) [A (d)(4)(A) payback trust];

(B) [A Medicaid Income (or "Miller") Trust]; or

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corpus shall be considered a transfer of assets by the individual as of the date of the establishment of the trust and payment from the trust after this date shall be disregarded.").

Under the Committee bill, these rules do not apply to the following types of trusts: (1) trusts established for the benefit of a disabled individual by a parent, grandparent, or other representative payee (including a court or administrative body) of the individual; and (2) trusts composed only of pension, Social Security, and other income [in states that limit nursing home eligibility to individuals with income below a specified amount].

Id.

(C) [A pooled trust.][35]

Thus, subsection (d) of 1396p states that penalty periods are assessed against transfers to trust unless the trust is a (d)(4) trust. This specific language would appear to control over the more general language of subsection (c).[36] The general divestment statute at section (c) does not apply to pooled trusts because the specific statute governing trusts (at section (d)) exempts pooled trusts from divestment transfer penalties.[37] Moreover, the general exception for divestments to trusts relates to transferring assets to trusts which benefit third parties, not to pooled trust accounts that solely benefit the people who fund them. Most importantly, if an under-65 limitation would apply to transfers to pooled trusts, it would render a nullity the statutory creation of (d)(4)(C) trusts which were specifically intended for grantors without regards to age.

Finally, even if the states' strained statutory analysis is correct, transferring assets to an irrevocable trust for one's own benefit (as a beneficiary) cannot be construed as a transfer for less than fair market value; a transfer to a trust with retained beneficiary rights it not a "gift" but an exchange of legal ownership for equitable ownership.[38] Individuals transferring assets to an irrevocable trust of which the individual transferor is the sole lifetime beneficiary have not made a gift in the sense of transferring assets outright or in trust to a son or daughter. Legal ownership

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[35] 42 U.S.C. § 1397p(d)(3), (4) (emphasis supplied).

[36] *See* Estate of Bonwa v. D.H.F.S., 2003 WI App. 152, ¶¶ 30-32, 265 Wis.2d 913, 668 N.W.2d 122; *see also* Skindzier v. Comm'r of Social Services, 784 A.2d 323 (Conn. 2001).

[37] The legislative history is supportive of this analysis. *See* CRS Bill Summary description of § 5111, H.R. 2138, 103rd Cong., 1st Sess. (1993) (stating that (d)(4) "exempts certain trusts for the benefit of disabled individuals from the transfer rules").

[38] *See* State Medicaid Manual § 3259.7.B, CMS Pub. 45. *See also* Marjorie A.G. v. Dodge County DHS, 659 N.W.2d 438 (Wis. App. 2003); Department of Social Services v. Saunders, 724 A.2d 1093 (Conn. 1993).

has been exchanged for equitable ownership. But a gift or transfer for less than fair market value has not occurred.[39] Thus, divestment ineligibility penalties should not apply.

V. ASSET PROTECTION TRUST PROVISIONS

(or "Protecting Trust Beneficiaries from Themselves and Others")

"Asset protection" can be defined as advance planning techniques which make it more difficult or impossible for one's potential creditors to reach certain assets. Asset protection planning for individuals with disabilities is especially important given their higher likelihood of making poor decisions, being subjected to pressure or coercion, or otherwise being at risk generally to wealth-loss from one cause or another. Arguably, spendthrift protections in trusts for disabled beneficiaries are even more important than securing or maintaining Medicaid eligibility. In South Dakota and the other states which have adopted Domestic Asset Protection Trust statutes, it is now possible to create spendthrift protections in (d)(4)(A) payback trusts and (d)(4)(C) pooled trusts.

But before a discussion of the different asset protection strategies can be undertaken, background into state law concerning what assets and interests are potentially subject to execution and an overview of how asset protection transfers can be overturned is required. No asset protection strategy is foolproof and no asset protection strategy should be viewed as a substitute for (1) comprehensive insurance through a reputable and solvent insurance carrier as to

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[39] See State Medicaid Manual § 3259.7.B.2 at page 3-3-109.34.

> Resources placed in an exempt [pooled] trust for a disabled individual are subject to imposition of a penalty under the transfer of asset provisions unless the transfer is specifically exempt from transfer [i.e., for trusts funded for third parties] or unless the resources placed in the trust are used to benefit the individual and the trust purchases items of services for the individual at fair market value.

Id.

assets (e.g., property, vehicles) or activities that can be insured, and (2) making decisions on a day-to-day basis which minimize exposure to undue risk.

a. Fraudulent Transfer Considerations

Transfers of property are subject to being reversed in certain circumstances. Gifts or partial gift transfers of assets, property or funds made when one is faced with a creditor's pursuits are "fraudulent" and can be overturned.[40] Funding and irrevocable trust should always be considered in connection with the possible application of the fraudulent transfer rules. The basic principle behind fraudulent conveyance law is that if a court finds a transfer was fraudulent, a creditor can undo the transaction, and may be able to assess additional penalties, such as shifting attorney fees.

The state law of "fraudulent conveyances" is a necessary background in any discussion of asset protection strategies and irrevocable trust funding. The term "fraudulent" in this context does not mean criminal fraud or wrongdoing; rather, it is a much broader concept which *includes* transfers of property and obligations incurred with the actual intent to delay or defraud a creditor. A creditor would include, of course, any person to whom a debt is owed by virtue of a contract. A creditor would also include any successful civil litigant; i.e., judgment creditors. Whether a transfer was made with the intent to hinder any creditor is generally a question of fact.

Fraudulent transfer law also reaches *future* creditors; that is, creditors for whom a claim has not matured as of the date of the asset transfer. Thus:

> Any transfer made or obligation incurred by a debtor is "*fraudulent*" as to a creditor, whether the creditor's claim arose *before or after* the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

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[40] SDCL §§ 54-8A-1 *et seq.* Fraudulent transfer laws vary widely; South Dakota's are cited here by means of providing authority in connection with a general discussion and overview of fraudulent transfer rules.

(1) With actual intent to hinder, delay, or defraud any creditor of the debtor; or

(2) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor

(i) Was engaged or about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(ii) Intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they became due.[41]

Whether "actual intent" exists under subsection (1), above, depends on a multi-factored analysis including whether the transfer was made after the debtor had been sued or threatened with suit.[42] Another factor is whether the transfer was in exchange for fair consideration; that is, whether the transfer was a gift or bargain sale. A close relationship between the parties to a conveyance is also a factor which weighs in favor of an unhappy creditor.[43] Still another factor is whether the person was insolvent when the transfer was made.

These factors are termed "badges of fraud" which assist creditors in convincing a court that a given transfer should be undone. No one badge of fraud is conclusive in itself. Several badges together may lead to an inference of fraud. If a creditor is successful in overturning a transfer in accordance with these statutes, there are a number of remedies available including avoiding the transfer, attaching the transferred asset itself and obtaining injunctive relief.[44]

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[41] SDCL § 54-8A-4.

[42] SDCL § 54-8A-4(b)(4).

[43] *See, e.g.,* Andrews v. Reynolds, 409 N.W.2d 128, 130 (S.D. 1987).

[44] SDCL § 54-8A-7.

The application of the fraudulent transfer remedies can be rebutted by a showing that the transfer was undertaken "in good faith and for a reasonably equivalent value."[45] There are various statutes of limitations for attacking transfers which range from one to four years.[46] Even where a transfer successfully avoids the reach of a creditor, the individual may face a court order to hand over certain assets. Courts also have the authority to order the disclosure of the location of assets. By failing to do so, a court may hold him or her in contempt.[47]

b. Exemptions

State and federal law do provide some limited exemptions and rules which provide for the protection of one's assets from seizure, attachment or garnishment, even in the absence of specific planning.[48] The homestead exemption is one with which many people are familiar,

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[45] SDCL § 54-8A-8.

[46] SDCL § 54-8A-9.

[47] *See* F.T.C. v. Affordable Media, LLC, 179 F.3d 1228 (9th Cir. 1999) (also known as "the Anderson case"). The *F.T.C.* case involved a telemarketing scheme by a husband and wife that the court described as "a modern day telephonic Bonnie and Clyde." The couple's ill gotten profits were tucked away in an irrevocable offshore Cook Island trust which the couple refused to repatriate. Although the federal court lacked any jurisdiction over the offshore funds, the couple was held in contempt of court and imprisoned. The court was unmoved by the couple's assertions that they could not comply with the court order because they had no control over the trust funds. The court held that immunity from a contempt order on the grounds of impossibility of compliance is not available when the impossibility is self-created. The trust assets were in fact unavailable to the couple, who spent several months in jail for contempt of court and were eventually released, at least in part because they may have demonstrated that it was indeed impossible for them to regain their assets.

[48] There is an exemption under South Dakota law for family pictures, a pew, the family Bible, a burial lot, $200 in books, all wearing apparel and clothing of the debtor and his family, and one year's provisions and fuel. SDCL § 43-45-2. In addition, $6,000 in value of a debtor's designated personal property is exempt (limited to $4,000 if not the head of the household). Because this last exemption is not absolute, it must be affirmatively claimed in order to be recognized. The proceeds of life insurance up to an amount of $10,000 for the benefit of a surviving widow or children are specifically exempt from creditor claims. This exemption covers the proceeds or surrender value of an insurance policy, not the face amount. When applicable, the exemption bars creditors of the deceased as well as creditors of his or her

although its protections vary significantly from state to state. Any retirement accounts which an individual with a disability inherited or generated prior to the onset of the disability also enjoy creditor protection benefits.[49]Social Security benefits are with few exceptions exempt from creditor claims.[50] Veteran's benefits also enjoy exempt status.[51] For these reasons, Social Security and Veteran's benefits always should be segregated from non-exempt funds.

The state statutory exemptions do not apply to protect exempted assets from the reach of creditors whose claim arose from providing necessities of life (such as food, clothing and fuel). Nor do they apply to support obligations, assistance furnished through a Medicaid Agency, or to anyone in the act of removing his family from the state.

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surviving spouse or child. South Dakota Codified Law also provides, in a separate section, that the proceeds of a life or health insurance policy shall inure to the use of the insured, a surviving spouse, or children independent of the creditors of any of them in an amount not to exceed $20,000. Annuities are protected by a certain degree by state law. An income annuity stream is exempt from creditors in an amount not to exceed $250 per month. The protection for annuity payments does not extend to payments made under a life insurance contract, however.

[49] South Dakota and many other states exempt certain retirement benefits: A person is permitted to designate a total of $200,000 (as well as the income distributions therefrom) from employee benefit retirement plans under South Dakota. This includes § 403(b) plans. South Dakota law also designates as exempt municipal retirement pension benefits. Federal ERISA law prohibits the alienation of qualified plans and because federal law preempts state law, qualified retirement plans are exempt from creditor claims in South Dakota..[49] Not all retirement benefits fall within the ambit of ERISA, however; IRAs, for example are not qualified plans. IRAs now have creditor protection features under federal bankruptcy law. Up to $1 million of IRA assets (including earnings), or more, "if the interests of justice so require," are exempt assets in bankruptcy. The $1 million IRA cap is adjusted for inflation every 3 years. Some commentators believe that the cap does not apply to any IRA amounts attributable to eligible rollovers from non-IRA plans.

[50] 42 U.S.C. § 407; 26 U.S.C. § 6331(h). Social security benefits are not immune to claims for unpaid student loans and the IRS can reach up to 75% of the benefits through federal tax liens.

[51] 38 U.S.C. § 5307.

c. Trusts as Asset Protection Devices

A trust, standing alone, is ineffective as an asset protection device. Revocable living trusts ("living trusts") are a commonly used estate planning tool, but because they are revocable and within the control of the grantor, fail to provide any measure of asset protection from creditors. Trusts where the grantor retains the power to revoke, the right to receive income, or the right to direct trust assets at death, are frequently attacked (though with varying degrees of success) by zealous creditors. Certain types of trusts, however, can be helpful asset protection tools.

i. Offshore Trusts

An offshore trust is a sophisticated and intricate asset protection technique where one's assets are owned by a trust with a foreign situs (e.g., in Belize, the Cayman Islands or Cyprus, with the Cook Islands being the most popular situs) with a foreign corporate trustee.[52] Offshore trusts – like special needs trusts – grant the trustee very broad discretionary distribution powers. Creditors are deterred largely because of the expense associated with litigating in foreign jurisdictions.

ii. Third Party Trusts

A third party spendthrift trust is a trust where the beneficiary is prohibited from using the trust principal as collateral on loans and creditors of a beneficiary are prohibited from attaching anything other than the income payments and distributions as they are made. An irrevocable trust for the benefit of a third party (such as a child) can provide important asset protection benefits. A third party spendthrift trust is one of the most simple, inexpensive and effective asset protection tools available. The limitation on their use is that they can only be created for the

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[52] A 1994 article in TAX ADVISOR estimated that more than $1 trillion in foreign trust funds were held in APTs.

benefit of others; an individual cannot create a spendthrift trust for himself or herself, unless a domestic or overseas domestic asset protection trust is used.

iii. Domestic Asset Protection Trusts (DAPTs or "Alaska Trusts")

Domestic asset protection trusts were authorized in Alaska in 1997. Alaska permitted a settlor of a trust to be a discretionary beneficiary without exposing the trust to claims of the settlor's creditors (with certain exceptions). There are a number of unsettled legal issues concerning domestic asset protection trusts. Creditors could make a number of federal constitutional arguments against the state legislation purporting to authorize these trusts. To date, no court decisions have yet determined whether these attacks would be successful.

South Dakota authorized domestic asset protection trusts (DAPTs) in 2005.[53] A qualifying DAPT must expressly incorporate South Dakota law, have at least one South Dakota trustee, and be irrevocable. The grantor can be a trust beneficiary, so long as the Trustee's authority to make distributions to the grantor do not exceed the limitations of the state act. Although the statutes do not expressly authorize incorporating DAPT provisions into d4a or d4C trusts, it is generally straightforward to include DAPT provisions in these types of trusts. The South Dakota Act permits the individual creating the trust to retain the following rights:

~ Veto power over distributions;

~ Income rights to trust property;

~ Rights to 5% of the principal balance of trust property annually;

~ Additional rights to principal in the trustee's discretion; and

~ The power to appoint to whom trust assets are distributed upon the grantor's death (with certain minor limitations).

[53] SDCL ch. 55-16.

The South Dakota Act carves out two major exceptions to the creditor protection benefits of a DAPT:

~ Creditors claiming child support, alimony, and divorce decrees of property division are not protected; and

~ Claims for death, personal injury or property damage caused by the grantor on or before the date the trust is created are not protected.

As with all spendthrift trusts, once a distribution is actually made by the trustee and received by the grantor/beneficiary, it becomes an asset which is no longer protected from creditors. In addition, creditors will sometimes be able to bring a fraudulent transfer claim associated with the funding of a DAPT.[54] However, the South Dakota Act requires creditors to meet a very high burden of proof to do so. If an individual's financial situation so deteriorates that bankruptcy is triggered, the 2005 amendments to the Bankruptcy Code provide for a ten year "look back" period for transfers to self-settled trusts if a creditor can prove that the trust was intended to defraud and hinder creditors.[55]

There are additional limitations to the protections of a DAPT when state lines are crossed. Self-settled spendthrift trusts are considered to be against "public policy" in some states. Thus, if the trust owns assets in another state, the protections of South Dakota law may not be recognized if a creditor brings an action to satisfy a judgment against assets outside of South Dakota. Protections are at their highest when:

~ The Trustee is truly independent of influence or control by the grantor;

~ The Trust instrument scrupulously adheres to the requirements of law;

~ The Trust is funded with assets located in South Dakota;

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[54] *See supra.*

[55] 11 U.S.C. § 548(e)(1)(A).

~ Any lawsuit arises out of events in South Dakota occurring after the trust was created; and

~ If bankruptcy is involved, ten (10) years passes between the funding of the trust and the filing of a bankruptcy petition.

Individuals who are non-residents of South Dakota may avail themselves of the benefits of South Dakota DAPT statutes so long as the requirements of the statutes are met. These individuals, however, are at higher risk to sister state jurisdictions who permit "trust busting" of DAPTs.[56] The Pooled Advocate Trust incorporates full DAPT provisions and thereby benefits trust beneficiaries with a great deal of asset protections for their sub-account balances.

VI. LAWSUIT SETTLEMENT DYNAMICS AND ISSUES

(or "How to Talk to Plaintiff's Counsel")

Pooled d4C trusts are often seen as an option for plaintiffs' lawyers settling lawsuits or obtaining verdict proceeds in connection with personal injury claims on behalf of disabled individuals. Special considerations come into play when a plaintiff poised to recover money is an individual with a disability.[57] Cash cannot simply be delivered to such a person if the person is legally incapacitated and unable to manage their own assets. Instead, recovered funds must be delivered to a third party for the plaintiff's benefit. This third party can be a trustee, a custodian, or a conservator. In most circumstances, the use of a trust offers greater flexibility and better protections of the plaintiff/client's interests. Not uncommonly, however, attorneys select a conservator or custodian to hold settlement funds in the interests of perceived cost savings or out of a desire to avoid delays. These options are viewed as less expensive for the client, easier to

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[56] *See* David G. Shaftel and David H. Brundy, *Domestic Asset Protection Trusts and the Bankruptcy Challenge*, 32 ESTATE PLANNING 5, 11 (May 2005).

[57] Parts of this section originally appeared in Thomas E. Simmons, *Using Trusts to Settle Lawsuits*, 19 PROBATE & PROPERTY 6 (2005).

self-administer, and avoid the need to consult with a trusts attorney, but closer examination, the reasons cited against the use of a trust usually disappear.

a. Conservatorship Accounts

Some – probably most - individuals with disabilities are legally competent to manage their own affairs. When this is the case, the individual can receive funds in their own name. Under the Uniform Probate Code (adopted in 18 states), a conservator may be appointed for an adult only when the adult's "ability to respond to people, events, and environments is impaired to such an extent that the individual lacks the capacity to manage property or financial affairs . . . without the assistance or protection of a conservator." When this standard is met, the individual (a "ward" or "protected person") is eligible for a conservatorship. Of course, monies in a conservatorship will be considered the individual protected person's funds for purposes of determining eligibility for Medicaid.

b. Trusts as Alternatives

Whether or not a plaintiff with a disability suffers from a legal incapacity, the use of a supplemental needs trusts is always preferred whenever eligibility for benefits such as Medicaid, Supplemental Security Income (SSI), or public housing are present. Medicaid and SSI eligibility are, generally speaking, governed by the same set of rules, although Medicaid is overlaid with a gloss of state statutes and rules. These rules provide that, with very narrow exceptions, amounts in trust are deemed an available resource to the beneficiary, resulting in ineligibility for these public programs. The idea of a supplemental needs trust is to carefully restrict the authority of the Trustee to make distributions in order to preserve public benefit eligibility. The Trustee is permitted to make distribution which supplement, but not replace, the benefits the beneficiary

receives. This restriction results in preserved eligibility because the terms of the trust do not permit the Trustee to pay for expenses which public benefits are already supplying.

When the settlement proceeds are essentially the property of the individual with a disability, any trust that would be created would be "self-settled." Either the individual plaintiff or the court would fund the trust. In these circumstances, only two supplemental needs trust options can be considered: a "(d)(4)(A) payback trust" or a "(d)(4)(C) pooled trust." These trusts are defined by federal law[58] at, as well as state statutes and regulations implementing the Medicaid program on a state-by-state basis. With either a pooled trust or a payback trust, any remaining funds will not pass to a deceased beneficiary's heirs. This can be a major issue for parents of an injured adult child with a reduced life expectancy as there may be significant unspent funds remaining at death which may pass to the parents if a conservatorship were instead utilized. A supplemental needs trust, on the other hand, will help sure funds are available for a longer period of time to enrich the injured person's life. Duties of loyalty and client identification come to the forefront in recommending the trust option versus a conservatorship.

c. Income Tax Issues

If funds for an individual with a disability are held in a conservatorship, no unique income tax rules are triggered. Essentially, tax neutrality is achieved. Investment income will be taxed to the individual and reported on a 1040. For trusts, however, the rules are different.

The highest marginal rate of 35% for non-grantor trusts is triggered at just $10,700 in annual income.[59] For trusts with significant income which is not distributed, therefore, higher taxes may result through the use of a trust. This is not the case for trusts with smaller amounts of

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[58] 42 U.S.C. § 13960(d)(4)(A), (C)

[59] The top taxable rate for trusts of 35% is reached at taxable income of $10,700 for tax year 2008; the amount is adjusted annually.

income, however. A form 1041 tax return need not be filed for the trust unless its gross annual income exceeds $600.[60] Oftentimes, tax-free municipal bonds or other tax efficient investments like exchange traded funds or individual common stocks can reduce the effect of steeper graduated rats applicable to trusts. Generally, trust distributions to a beneficiary will result in taxable income to the beneficiary. The trust itself can deduct distributions it carries out, which can soften or eliminate the effect of income taxes on trust investments. The trust will be entitled to a $300 exemption. The trust can deduct any trustee fees. Trusts, depending on how they are drafted, also do a better job of helping college students qualify for financial aid.

If funds for an individual with a disability are held in a supplemental needs trust, the tax treatment will vary greatly depending on the way in which the trust is drafted and administered. Trusts are considered independent persons and therefore independent taxpayers by the IRS. Supplemental needs trusts generally pay income tax on income in excess of a $100 exemption. The trusts are also entitled to deduct "distributable net income" which is distributed to the beneficiary in order to avoid double taxation. The beneficiary will report any distributions he or she receives as income on his or her 1040.

An additional tax option became available for supplemental needs trusts in 2002. An special needs trust which meets the requirements of a "qualified disability trust" will result in an increased exemption to $3,700.[61] Thus, a qualified disability trust can retain up to $3,700 in income, adding it to principal free from both federal income tax, as well as most state income taxes. Without the exemption, a trust is limited to a $100 (for simples trusts) or $300 (for complex trusts) exemption. The Qualified Disability Trust exemption was enacted as part of the

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[60] I.R.C. § 6012(a).

[61] (for 2007; indexed for inflation); IRC § 643(b)(C).

Victims of Terrorism Tax Relief Act of 2001.[62] Because the beneficiary is also entitled to an additional personal exemption for income distributed to him or her, the use of a qualified disability trust can achieve significant tax savings (i.e., as compared to a conservatorship).

A qualified disability trust, as defined by the Internal Revenue Code, means a trust which is established "solely for the benefit" of the individual with a disability[63] under 65 years of age. The trust must otherwise meet the requirements of a (d)(4)(A) payback trust or a (d)(4)(C) pooled trust. And the trust must be irrevocable.

VII. CONCLUSION

(or "The End")

With only a few exceptions, trusts are the preferred vehicles for settlement funds for children or individuals with disabilities because of greater flexibility and protections for the individual beneficiary. Oftentimes, trusts are overlooked by plaintiff's attorneys because of the perceived costs or delays in waiting for the busy trust attorney to complete the drafting process. Upon closer examination, these perceived disadvantages disappear in nearly every situation.

The Pooled Advocate Trust saga – as of the date these materials were prepared – is not yet over. It remains to be seen whether the age-related arguments being articulated by State Medicaid Agencies will ultimately limit the availability of pooled trusts to younger beneficiaries.

Thomas E. Simmons
University of South Dakota School of Law
Vermillion, SD 57069
Email: tom.e.simmons@usd.edu

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[62] Public Law 207-134, enacted January 23, 2002.

[63] The beneficiary, as of the end of the taxable year, must have been determined by the Commissioner of Social Security to have been disabled for some portion of the tax year. Therefore, the beneficiary must actually be receiving SSI, SDI, or in some cases Medicare. A trust taxed as a grantor trust cannot take advantage of the exemption.