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Using Trusts to Settle Lawsuits

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Special considerations come into play when a plaintiff poised to recover money is a child or an individual with a disability. In the context of settling a lawsuit or receiving judgment proceeds, cash cannot simply be delivered to such a person because of the plaintiff's legal incapacity. 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 simply a minor's account 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 self-administer, and a way to avoid the need to consult with a trust attorney.

On closer examination, however, the reasons cited against the use of a trust disappear in nearly every situation. A trust can be more efficient in terms of both costs and the time required for initial implementation. When properly structured, trusts also can offer income tax advantages.

The discussion that follows applies most commonly in connection with the settlement of a personal injury claim involving an injured child or individual with disabilities. Application also could be made, however, to other tort plaintiffs, wrongful death beneficiaries, or minors or disabled persons who receive unanticipated inheritances. The discussion in many cases could apply with equal weight to the ways to manage funds from a verdict or judgment.

I. Minors

When the injured plaintiff is a minor, he or she is considered legally incompetent without regard to the individual's actual financial acumen or maturity. Because of this legal incompetency, a minor may not receive funds or proceeds; title must vest in another person for the minor's benefit.

With minors—unlike individuals with disabilities—incompetency will disappear at a predictable point in time. If a settlement occurs any time before this date, however, arrangements must be made to accommodate the incompetency. This is true even if the minor will reach the age of majority in a matter of months or weeks, unless settlement can be delayed until the relevant birthday.

Custodial Account

Attorneys often look to the use of a custodial account at a bank or credit union when the anticipated settlement is relatively small. All but two states have adopted a version of the Uniform Transfers to Minors Act (UTMA). Vermont and South Carolina still retain the uniform act's predecessor, the Uniform Gifts to Minors Act (UGMA). Legislation is pending in Vermont to adopt UTMA. An UTMA account will vest in the minor's control and absolute ownership when the minor attains the age of majority or the age defined in the state's adoption of the Act (generally, age 21, although a few states permit the person creating the account to specify a later age, up to age 25).

While the minor remains a minor, the account is titled in the name of the custodian “as custodian for the beneficiary.” The custodian may—but need not necessarily—be the minor's parent or legal guardian. The custodian may be an entity such as a trust company. Joint custodians also may be used.

UTMA accounts are simple and inexpensive. No legal fees are required to set up or administer the account, other than initial court approval and standard account fees or minimum balances that may apply. No bond for the conservator is required except when an interested party has successfully petitioned a court for the requirement of bond. Cash as well as investments, real property, annuities, and life insurance products may be held by a custodian.

Unfortunately, UTMA lacks any specific guidance on when and how a custodian should expend funds for the minor's benefit. Spending power is clearly not unrestricted. Any expenditure of funds must be for the benefit of the minor. But what actually constitutes spending for the minor's benefit is distressingly vague and undefined.

Typically, UTMA accounts are not court supervised. Because of the absence of statutory guidance and court oversight, selection of a proper custodian is critical. Cases in which a custodian used UTMA account funds for the custodian's own benefit are numerous. To make matters worse, some courts have even held that UTMA assets expended for purposes other than the minor's benefit become exposed to the creditors of the custodian. Legal malpractice for failing to exercise due care in the selection of a custodian is a real possibility.

If the minor passes away before reaching the age set by statute, the assets in the account pass to his or her estate. In most cases, this will require a probate proceeding and distribution according to the laws of intestacy.

UTMA permits the designation of successor custodians, to plan for the contingency of the first custodian's death or incapacity. When a successor custodian has not been designated, a minor's conservatorship or other court proceeding may be required.

Minor's Conservatorship

A minor's conservatorship is a court proceeding that appoints a person as conservator (or guardian, in some states) with the power to invest, administer, and distribute the minor's funds for the minor's benefit. Individuals as well as corporate trustees often serve as conservators.

Conservatorships benefit from more detailed statutory definitions of the conservator's role and responsibilities. Court oversight on at least an annual basis in the form of statutorily required accountings is an additional advantage, although the result is additional legal fees. One benefit to court oversight takes the form of protections for the minor, as any improper or questionable expenditures or investments are likely to be identified and corrected earlier.

A benefit of court oversight from a conservator's perspective is to permit the conservator to receive res judicata approvals of the conservator's actions during a reported accounting period. A conservator considering an expenditure that could be seen as improper can seek advance judicial guidance before making the expenditure. The purchase of a hot tub for a minor's physical therapy regimen, for example, might be legitimate, but other family members—

including possibly the conservator—also may enjoy the tub. In this type of conflict of interest scenario, court approval can give the conservator peace of mind and eliminate the possibility of future litigation.

In cases in which ongoing court supervision is unwarranted, because of the value of the minor's assets in relation to the ongoing legal fees, most states permit the court to waive or reduce ongoing accounting requirements on a showing of good cause. In certain circumstances, the conservator can be required to post a bond in addition to, or in lieu of, future court accountings.

A minor's conservatorship terminates when the minor attains the age of majority unless a disability qualifies the minor for a continuing conservatorship. Any conservatorship assets remaining on a minor's premature death would be distributed to the minor's estate. Again, intestacy and a probate proceeding would likely result.

Minor's Trust

The third option for a minor who is poised to receive a settlement amount is a trust. Trusts offer a great deal more flexibility than either an UTMA account or a conservatorship. Distribution standards can be clearly articulated. Final distributions to the minor can be delayed beyond age 21 or 25. A bond for the trustee may be required or waived by the trust instrument itself. Professional investment services from an institutional trustee or the use of family members as trust advisors is also possible.

In terms of legal fees, the drafting of a minor's trust is usually on a par with the fees necessary to implement a conservatorship. Court supervision of a minor's trust is available, but optional. The use of a corporate fiduciary, such as a bank trust company, can increase costs in the form of trustee fees but reduce the need for ongoing court proceedings. Although corporate fiduciaries earn their fees through professional investment decision making and experienced fiduciary management, family members may resist the use of corporate fiduciaries from a wish to eliminate trustee fees and retain control of the funds.

Often, final distributions from a minor's trust are staggered. This may be the single greatest advantage to a minor's trust. Rather than dropping a single lump sum on the minor at a relatively young age, lump sums can be fractionalized and spread over time. Not uncommonly, the trust would distribute one-third of the principal to the minor at age 21, half of the remainder at age 25, and the rest at age 30, while continuing to make additional distributions for education, health care, and support as needed.

Whenever a minor's trust is used in these scenarios, it contains detailed provisions regarding contingencies such as the minor's premature death or the trustee's inability to continue to serve. These contingencies can avoid probate costs as well as serve to plan around an intestacy situation.

In almost every situation, a minor's trust will be irrevocable. In some states (Alaska, Delaware, and South Dakota, for example), spendthrift protections can be added that protect the trust assets from most creditors of the minor beneficiary. Spendthrift protections can be especially attractive for young persons who tend to engage in higher risk activities that expose them to a greater likelihood of a lawsuit.

Income Tax Issues

The use of an UTMA or conservatorship to manage a minor's settlement funds is tax neutral. The income in either vehicle is taxed to the child at the child's rate, which is an advantage when the child pays tax at a lower rate than the parent. But the so-called “kiddie tax” eliminates most of this benefit for children under age 14.

Young children are effectively entitled to an $800 standard deduction. Thus, smaller accounts in which the child's investment income is $800 or less annually should owe no taxes. Children under age 14 who have investment income of $1,600 or more will have to pay income taxes based on their parents' highest rates, the unpopular “kiddie tax” rule. Parents may have the option of reporting the income on their own return or filing a separate tax return for the child.

Minor's Trust Tax Advantages

Income tax issues for a minor's trust can be more complicated, but not necessarily less advantageous. Unlike a custodianship or conservatorship, a trust is a separate entity. Thus, a trust will be considered a separate taxpayer and subject to trust income tax rules. Trusts are notorious for their steep marginal rates.

The highest marginal rate of 35% for nongrantor trusts is triggered at just $9,750 in annual income. For trusts with significant income, therefore, higher taxes may result through the use of a trust. This is not the case for trusts with smaller amounts of income, however. A Form 1041 tax return need not be filed for the trust unless its gross annual income exceeds $600. Often, tax-free municipal bonds or other tax-efficient investments like exchange-traded funds or individual common stocks can reduce the effect of steeper graduated rates applicable to trusts.

Trust distributions to minors will result in taxable income to the minor, subject to the kiddie tax rules. 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.

II. Plaintiffs with Disabilities

When the plaintiff is an adult with a disability, many of the same issues and considerations are present. Costs, flexibility, taxes, and careful selection of the appropriate person or entity to manage the funds are key. UTMA accounts are unavailable options, and, when public benefits are involved, a special needs trust should always be considered.

Conservatorships

Most individuals with disabilities are legally competent to manage their own affairs. When this is the case, the individual can receive funds in his or her own name, just as any other plaintiff.

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.

Monies in a conservatorship will be considered the individual protected person's funds for purposes of determining eligibility for needs-based programs, such as Medicaid. If the individual with a disability has ongoing medical expenses, the settlement proceeds would need to be exhausted or “spent down” before Medicaid or other programs would become available.

Supplemental Needs Trusts

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 is a concern. 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 (SNT) is to carefully restrict the authority of the trustee to make distributions so that public benefit eligibility will be preserved. The trustee is permitted to make distributions that supplement, but do 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 that 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 at 42 U.S.C. section 1396p(d)(4)(A), (C) as well as by state statutes and regulations implementing the Medicaid program on a state-by-state basis.

A (d)(4)(A) 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.

A (d)(4)(C) pooled trust must be managed by a nonprofit association that pools investments but that maintains separate accounts for each beneficiary. When a beneficiary of a pooled trust dies, the trust need only "pay back" the state Medicaid program to the extent that amounts are not "retained by the trust."

Various interpretations have been advanced for what the "retained by the trust" requirement for pooled trusts means. Some trusts retain amounts for the benefit of other surviving trust beneficiaries, but others use funds to benefit nonprofit or charitable agencies. No federal statute restricts pooled trusts to beneficiaries under age 65, but pooled trusts are not available in every state. One of the premier examples of a pooled trust is the ARC of Texas pooled trust, but availability is restricted to residents of Texas.

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 because unspent funds may remain at death that might pass to the parents if a conservatorship were used instead. A supplemental needs trust, on the other hand, will help make 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.

Income Tax Issues

If funds for an individual with a disability are held in a conservatorship, no unique income tax rules are triggered. As with conservatorships for minors, tax neutrality is achieved. Investment income will be taxed to the individual and reported on a 1040 form.

SNT Tax Advantages

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. Because 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 to avoid double taxation. The beneficiary will report any distributions he or she receives as income on his or her 1040 form.

An additional tax option became available for supplemental needs trusts in 2001. An SNT that meets the requirements of a “qualified disability trust” will result in an increased exemption from $100 to $3,100 (in 2004, indexed for inflation). Code § 643(b)(2)(C). Thus, a qualified disability trust can retain up to $3,100 in income, adding it to principal free from federal income tax, as well as most state income taxes. Because the beneficiary also is 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 as compared to a conservatorship.

A qualified disability trust, as defined by the Internal Revenue Code, means a trust that is established “solely for the benefit” of the individual under 65 years of age with a disability. The trust must otherwise meet the requirements of a (d)(4)(A) payback trust or a (d)(4)(C) pooled trust.

III. Conclusion

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 beneficiaries. Often, trusts are overlooked by plaintiff's attorneys because of the perceived costs or delays in waiting for a busy trust attorney to complete the drafting process. On closer examination, these perceived disadvantages disappear in most situations.

Footnote: Thomas E. Simmons is an attorney with the Rapid City, South Dakota, law firm of Gunderson, Palmer, Nelson & Ashmore, LLP, and is the president and founder of Pooled Advocate Trust, Inc. (PATI), a nonprofit 501(c)(3) corporation that manages the first (d)(4)(C) pooled trust for South Dakota residents with disabilities.