

# **A Primer for the Parents of a Child with Special Needs on Financial & Legal Options When a Personal Injury Case Settles**

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As the parent of a child with special needs with a lifetime of financial requirements, you can't ignore wealth management issues and public benefit preservation techniques. A parent of a child with special needs requires additional financial guidance as well as legal advice to ensure the child is taken care of financially and does not lose public benefits when the settlement proceeds are disbursed. The first part of this article will focus on the financial options at settlement for a personal injury victim. The second part of the article will address the different types of public assistance along with different types of trusts that can preserve public benefits, which are needs based. Finally, it will address some other financial products and tools to consider at settlement.

## **Taxability of Settlement Proceeds**

As a starting point, section 104(a)(2) of the Internal Revenue Code excludes from gross income any amounts received on account of personal physical injuries. "(G)ross income does not include...the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness." It gives personal injury victims two different options when accepting a settlement. The first option is to take all of the settlement proceeds in a single lump sum. If this option is selected, the lump sum is not taxable but once invested, the gains become taxable, and the settlement proceeds will impact the child's ability to receive needs based public assistance without the appropriate trust. The second option is receiving "periodic payments" via a fixed annuity commonly referred to as a "structured settlement." With a structured settlement, investment gains are never taxed, and the money is protected against creditor claims, judgments as well as wasting. A structured settlement recipient can avoid disqualification from public assistance when the annuity is used in conjunction with the appropriate trust.

## **The Lump Sum Option**

The main advantage to exercising this option is that the money is immediately available to your child any time it is needed. This is called liquidity. Unfortunately, this is also its biggest disadvantage because according to statistics, 90 percent of personal injury victims have nothing left of their settlement within five years of receiving the settlement proceeds. The sobering fact is that out of all the personal injury victims in the United States, you must be in the top 10 percent of money managers to have a chance of having anything left of your child's settlement within five years.

You must be wondering, why does this happen? There are many reasons such as: poor financial planning decisions or advice, spending the money too quickly, the money being stolen or misappropriated in some way, and a whole host of other reasons. Here are a few real life examples of ways people have lost all or part of their settlements:

- 1) In 1980, a Tennessee minor's settlement was invested by her father in his construction business, which failed by 1990, and the entire settlement was lost.

- 2) Between 1997 and 1999, a Florida man's 2.2 million dollar guardianship was misappropriated by his guardian, leaving only \$20,000 in the account by 1999.
- 3) According to a *New York Times* article, a 24-year-old with cerebral palsy from New York with ongoing medical needs lost almost 25 percent of his settlement due to questionable investments in junk bonds and technology stocks by the investment firm his guardian hired.
- 4) A Florida man rendered quadriplegic in an auto accident received a 2 million dollar lump sum settlement that was stolen by his new wife, who was a drug addict. The man died of neglect and lack of medical treatment as a result of his wife's failure to take care of his medical needs.

In addition, there are other disadvantages to taking a lump sum of cash. For example, your child's settlement money is exposed to creditor claims, judgments, or predators if it is invested in anything other than a structured settlement or trust. And, of course, a lump sum is an easy target for predators to take from the unwary, which is an especially troubling problem for those with special needs. Finally, the main disadvantage of taking a lump sum recovery is that you as the parent of a child with special needs will be in the position of managing a sum of money that may need to last your child's lifetime for medical and income replacement needs. Since most parents are not skilled at handling large sums of money, this is a very dangerous option for most children.

If you do decide to take your child's recovery in a lump sum payment, you can either manage the money by investing it on your own or hire someone to do it for you and pay his or her fees. Either way, the interest earned on the investments is taxable to you as ordinary income, and you may have to pay capital gains taxes. As a rule, taxes continue to go up and not down, so over time more of your interest will go to the government. There is also a danger that your future needs will not be met because of poor investment returns and the effect of paying taxes on your investments. Despite all of these drawbacks, it is typical for a portion of the settlement proceeds to be put into a vehicle that is liquid and can adapt to changes in circumstances.

### **The Structured Settlement Option**

Because of all the disadvantages and risks associated with taking an entire personal injury recovery in the form of a lump sum, Congress created structured settlement annuities. In a nutshell, a structured settlement is a tax-free annuity only available to personal injury victims. Its major benefits are that it transfers the risk of outliving the settlement to a large financially secure life insurance company; it is managed regardless of whether you are around to oversee your child's financial affairs and provides an income stream for the rest of your child's life or a for minimum guaranteed time period.

First and foremost, you must understand the concept of an annuity. An annuity is a life insurance product designed to turn a lump sum investment into some type of stream of income. It is typically fixed-meaning the rate of return is not based on the performance of the stock market. It can be variable, if desired, and appropriate, based on risk tolerance and financial situation. An annuity is simply a contract that says for a certain investment, the life insurance company agrees to pay a stream of income or lump sum payments. Below is a hypothetical example to illustrate how an annuity works:

Hypothetical Settlement, netting victim \$2,000,000:

Assume your child is going to receive \$2,000,000, and out of that, you wish to put \$1,000,000 into a structured settlement annuity for your child. A level lifetime income stream guaranteed for 25 years could be set up, which would provide \$5,000 per month. The 25-year guarantee means that if your child died prematurely, the payments would continue for 25 years to the child's named beneficiary. However, should your child live past the 25-year guarantee, the annuity payments would continue, but they would

be life contingent at that point ceasing at the death of your child. The beneficiary of a structured settlement receives the payments tax-free just like the injury victim. Another option would be to do the same life annuity but use a 3 percent cost of living adjustment, which would make the payments increase annually by 3 percent. The monthly benefit would start out lower at \$2,500, but over a lifetime, it would pay out much more than the level annuity. Finally, you could set up monthly payments for your child with an annual lump sum for unforeseen expenses. There are many options, and the plan can be tailored to your child's specific needs.

You must decide for your child before the settlement is finalized whether or not to set up a structured settlement. Once the defendant pays out the money, the option of a structured settlement is eliminated forever. The defendant must fund the structured settlement annuity directly, without anyone associated with the plaintiff ever touching the funds. The annuity is actually owned by the life insurance company, an arrangement which allows your child to receive the payments tax-free. But your child is the beneficiary or recipient of the payments. The checks come to your child and are made out to him, her, or a trust.

The major benefit of a structured settlement annuity is that even though the money is invested and earning interest, no taxes have to be paid on the growth because of the exclusion found in 104(a)(2). Congress decided to make this exclusion and give personal injury victims a tax break to encourage people to enter into structured settlements so that their money would be protected, and they would receive more money over time. This is so even if a variable annuity is selected, it avoids ordinary income taxation and capital gains taxes.

A structured settlement annuity protects personal injury proceeds from being spent too quickly: lost by poor money management or swindled away from your child. The payments are made to your child monthly or however it is decided they receive them. A structured settlement is not like a bank account where your child can simply withdraw funds. Your child can't accelerate, defer, or change the payments they receive after a plan is created. While this is an advantage, it is also a disadvantage. Some element of control over the money has to be given up in order to get the structured settlement tax-break.

Nevertheless, the many benefits that structured settlements provide outweigh the disadvantage for most people. In addition, a portion of the settlement should be in a liquid investment, which can be reached in unforeseen circumstances. A structured settlement can provide your child with a reliable stream of income tailored to his or her future needs. As discussed, you can have payments made monthly, quarterly, semi-annually, annually, and even lump sums paid into the future. A structure can be used to fund a life insurance policy to provide for a child's care in the event their primary caretaking parent passes away. In a case where there are high dollar future medical needs, the structured settlement can stretch out the proceeds to make them last a lifetime, ensuring that your child will not outlive the adjustment feature. A structure is an extremely flexible financial product that can be designed to meet your child's individual needs.

A structured settlement provides cost free financial management for your child. There are no ongoing fees charged by the life insurance company. There is no market risk if a fixed annuity is selected. This means the life insurance company is obligated to pay your child the benefits you have selected regardless of how the market performs. However, if a variable annuity is selected there is a market risk and some ongoing fees.

The structure provides worry-free financial management and avoids the risk and discomfort of managing a large sum of money for your child. A structured settlement annuity contract is issued by a large well-capitalized life insurance company – companies like Allstate, American General, Hartford, John Hancock, MetLife, New York Life, and Pacific Life, among others. Due to financial strength, these companies when utilized for a structured settlement annuity, make for very low risk investment.

Structured settlements and the complexities of settlement planning present many issues that require expert advice from a planner trained to address such issues. It is very important to carefully explore these issues as the passage of time or receipt of the settlement proceeds can adversely impact the ability to do such planning for your child with special needs. Additionally, it is particularly important to consider public benefits preservation trusts. The following section will address these trusts and when they are used.

### **Public Benefit Preservation**

As a starting point, you should be aware that a structured settlement alone will NEVER preserve needs based public assistance eligibility. While the structure is not an asset for purposes of qualifying for public assistance since the victim does not own it, the income it produces may disqualify a needs based public benefit recipient if it exceeds the maximum monthly income threshold. If your child is on public assistance, an elder law attorney should be consulted and a recommendation obtained on the viability of a special needs trust (SNT). A structured settlement is a financial planning tool and not a public assistance preservation mechanism when used on its own. A structured settlement can be used in conjunction with a special needs trust, which allows for tax-free income to still be an available option for your child with special needs.

Supplemental Security Income (SSI) and Medicaid are income and asset sensitive public benefits that require planning to preserve. In Florida and most other states, one dollar of SSI benefits automatically brings Medicaid coverage. This is very important, as it is imperative to preserve some level of SSI benefits if Medicaid coverage is needed in the future. SSI is a cash assistance program administered by the Social Security Administration. It provides financial assistance to needy individuals who are aged, blind, or have disabilities. To receive SSI, the individual must be aged (65 or older), blind, or have disabilities and be a U.S. citizen. The recipient must also meet the financial eligibility requirements. As you are aware, Medicaid provides basic healthcare coverage for those who cannot afford it. It is a state and federally funded program run differently in each state. Eligibility requirements and services available vary by state. Medicaid can be used to supplement Medicare coverage if your child has coverage under both programs. For example, Medicaid can pay for prescription drugs as well as Medicaid co-payments or deductibles.

A SNT is necessary if your child is receiving SSI or Medicaid. A SNT is a trust whose corpus or any assets held in the trust to not count as resources for purposes of qualifying for Medicaid or SSI. Thus, a personal injury settlement can be placed into a SNT so that the victim can continue to qualify for SSI and Medicaid. Federal law authorizes and regulates the creation of a SNT. 42 U.S.C. needs. Medicaid would still have to be repaid for services they provided from the date of creation of the trust until it is reformed. Similarly, if the trust were to be terminated, Medicaid would have to be repaid first before any assets are distributed.

Pursuant to 42 U.S.C. § 1396p(d)(4)(A), a SNT can only be established “if the 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 on behalf of the individual under a State plan under this subchapter.” Thus, any funds remaining in the trust at death first go to repay Medicaid for any and all benefits they have

provided the SNT beneficiary over his or her lifetime. The recovery is only for benefits provided subsequent to the creation of the trust. Therefore, if a third party lien was satisfied at the time of a personal injury settlement, the recovery from the trust would only be for accident related benefits provided after satisfaction of the lien. However, there could be Medicaid services prior to or during the treatment for the accident which gave rise to the lien that are not accident related that will have to be paid back out of the SNT.

However, a Pooled Trust pursuant to 42 U.S.C. § 1396p(d)(4)(C) requires that “to the extent that amounts remaining in the beneficiary’s account upon death of the beneficiary are not retained by the trust, the trust pays to the State from such remaining amounts in the account an amount equal to the total amount of medical assistance paid on behalf of the beneficiary under the State plan under this subchapter.” Thus, with a Pooled Trust, the non-profit can retain the funds at death to assist other members of the Pooled Trust, or it must pay back Medicaid.

The only exception to the payback requirement is for third party special needs trusts. Because these trusts are established with someone else’s money, no payback provision is required. Therefore, a third party SNT should be created in addition to a (d)(4)(a) if parents, other family members, or friends wish to give money to a child receiving SSI or Medicaid.

### **Other Tools to Consider**

While structured settlements and special needs trusts are very important concepts/tools to understand, they might not be a complete solution for all your child’s needs. For example, if you are your child’s primary caregiver, who would pay for and provide those services should something happen to you? Or what if your child is covered by your spouse’s health insurance, and what if you spouse lost his or her job? Who will manage assets in a special needs trust? Who can help manage assets if you just want to set up a trust fund for your non-Medicaid eligible child?

All of the scenarios described above can be planned for with different financial products. In the case of the death of the primary caretaker, that possibility can be planned for by the purchase of a life insurance policy on the primary caretaker. The special needs trust could purchase the policy from money placed into the trust or you could use a tax-free structured settlement to fund the future premiums for the policy. In the instance where your child is covered by private insurance, which might be lost, it is imperative to have a contingency plan from a financial perspective. This can be accomplished by setting up a trust for future medical care that can be tapped into in the event you child no longer has health insurance. In the alternative, if a special needs trust is set up at the time of settlement regardless of the current need for Medicaid, it could preserve the ability to get Medicaid coverage in the future should private coverage be lost.

If a trust is established, be it special needs or another type of irrevocable support trust, it is important to have a highly qualified professional trustee. If the trust is a special needs trust, it is a must to have a professional trustee well versed in preservation of Medicaid. Many trustees say they will administer a special needs trust, but it is highly specialized. Unless they have plenty of experience, your child might wind up in a situation where he or she has lost benefits due to the actions of the trustee. The trustee will be your partner in the financial future of your child and will protect his or her future eligibility for Medicaid so you want to be sure it is a company that has plenty of assets in case they make a mistake. A well-capitalized national trust company is preferable so there is a “deep pocket” in case you need to bring suit for a mistake.

In a situation where Medicaid preservation is not an issue, an irrevocable support trust may be a very good option. In this situation, a professional trustee can be an indispensable part of your child's financial plan for the future because the trustee can pick up for you should you pass away before your child. The trustee can protect and safeguard your child's assets as well as make sure your child receives the proper care. If a large national trust company is selected, it is likely they will be around well after you and your financial advisor are no longer there, which gives you some peace of mind about the future. The trust is an extra layer of asset protection, which may provide enhanced creditor/judgment protection. This becomes more important if settlement proceeds are not placed into a structured settlement. In a lot of cases, it makes sense to wrap the financial vehicles in a trust wrapper for the extra protections it provides.

### **Conclusion**

As you may have surmised by now, there are some very important decision and issues to consider when deciding what to do when your child's personal injury case is resolved. It is vitally important to seek expert advice for an experienced settlement planner about the different financial options before the settlement is finalized. It is better to start exploring these issues well before the case settles. The same is true for public benefit preservation. Involving an elder law attorney early on will help make it easier to quickly wrap up matters once the case actually settles. There are many competent experts who can guide you through these issues and make sure your child is protected for the rest of his or her life.

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