The Use of Escrow Agreements in Medicaid Planning

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This paper was presented to the first national invitational program for advanced practitioners in Elder Law on March 9, 2003 in Atlanta, Georgia. It has since been modified for a broader audience and updated as of June 2006.

In planning for the financial consequences of long-term care, it is often helpful to make transfers of assets to third parties. For example, many attorneys counsel their clients on gifting, loans, payment for services or other methods of transferring assets from the intended Medicaid-recipient to another person. These attorneys counsel their clients on the advantages and disadvantages of such transfers. One of the advantages is the hope that this money will benefit the transferor when they need it. One of the disadvantages is a loss of control over the assets and the lack of security on the transaction. Truth be told, children sometimes run away with their parents' money. Even the best-intentioned child (or other transferee) may become ill, die or otherwise leave the monies at risk. In a guardianship context, a judge may not allow asset transfers unless a secure arrangement with a proven custodian can be demonstrated.

"For Medicaid purposes, transfers in escrow inherit the characteristics of the underlying transaction. If, for example, a transfer of assets is made in exchange for a lifetime care agreement; so long as the transaction with the care provider would have been a fair market value transaction, then the transfer to the escrow agent is also a fair market value transaction."

This paper discusses the use of escrow arrangements as a means of bringing more safety to the Medicaid transfer process. This paper first explores the advantages of escrow arrangements and why the author has found them to be helpful to his clients. The paper then discusses why transfers to escrow agreements are not met with a period of ineligibility for Medicaid and why the escrowed assets cannot be counted. This paper then provides drafting and practice tips for the use of escrow agreements.

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An escrow arrangement, for the purposes of this paper, is defined as an agreement between at least three parties. One party is the transferor of assets, another party is the escrow agent and another party is the intended recipient of the assets.

In protecting client assets from the cost of long-term care, it may at times be prudent and more helpful to transfer assets to an escrow agent as opposed to those assets going direct to the intended transferee. With a reliable and experienced escrow agent, many advantages accrue to the transaction. Among these advantages are superior prevention against theft or misuse; security against non-performance on personal service contracts, the ability of the transferor to secure professional management of the funds; possible tax advantages; security and approval when a court-appointed guardian seeks to do Medicaid planning for a ward; the ability to bond and insure the transferred assets; and more.

Reasons an Escrow Agreement may be Beneficial

Security Against Theft or Misuse

If the transferee does not have the assets in his or her hands, the transferee cannot take the money and run. For example, if a gifting program is implemented, those funds would ordinarily go direct to the donee. Legally, those monies belong to the donee and donee can do whatever donee wishes to do with the gifted funds. It is unusual for a chosen transferee to run off to Tahiti with the money but it is not unheard of either. With gifts, it is legally permissible for the donee to not use the money for the donor. In reality, however, there is often an expectation, albeit not a legally binding one, that the gifts will be used for the benefit of the donor to supplement care. An escrow arrangement provides security for the funds in that the donee cannot get to the monies unless the donee's conduct meets the terms of the escrow agreement.

Security Against Non-Performance on Lifetime Care Agreements

Some prospective Medicaid applicants choose to hire a child or other person to provide lifetime personal care services. This is sometimes done with one lump-sum transfer of assets in exchange for a binding promise from a care provider to take care of the elder for the rest of the elder's life. The transaction is constructed to meet the Medicaid definition of a fair market value bargain such that the elder gets a lifetime caregiver without jeopardizing eligibility for Medicaid.[2] One of the risks of any personal service contract is that the service provider may fail to perform.

An escrow arrangement can bring a higher level of security to the lifetime care agreement. The escrow agreement can provide for periodic payments to the care provider and these payments can cease by the terms of the agreement if there is non-performance. The escrow agreement can also provide for what should happen if the care provider is taken ill and cannot perform or, likewise, what should happen if the care provider predeceases the elder.

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[2] *Thomas v. Department of Children & Families*, 707 So.2d 954 (Fla. 4th DCA 1998) (the author served as co-counsel on this appeal).

In the ordinary use of lifetime care agreements, the care provider receives one lump-sum payment. With the escrow feature, this same payment is made to an escrow agent. The escrow agent then parcels out the money to the care provider over a time schedule set in the agreement. The agreement can provide for a successor care provider, a line of successors or at least a method of securing a successor. If non-performance is established under the terms of the escrow agreement, the escrow agent stops making payments to the defaulting care provider and instead makes those payments to the successor.

Non-performance can be intentional but, more likely, non-performance is unintentional. Caregivers move away. They get ill. Some even die. With an escrow agreement that provides a means of succession, the elder has greater assurance of receiving care for life.

Control and Professional Management

When a prospective Medicaid applicant transfers his or her assets to a third party, there is a concomitant loss of control. There is also the concern that the funds will be squandered or poorly invested. An escrow agreement may bring with it the added benefit of professional financial management. This financial management could have been accessed by the transferee without an escrow agreement but the escrow agreement makes sure of it. Importantly, the escrow agreement allows the transferor (the elder) to control who is going to manage the funds and even how the assets are to be invested.

The escrow agent can be a professional who has more financial sophistication than perhaps the transferee. The escrow agent might be a professional money manager or other financial services provider. With this professional in charge of the monies, the odds are better that sound investment decisions will be made. Perhaps more important than whether sound financial decisions are in fact made is that the elder has chosen the person or entity that will be in charge. This ability of the elder to choose, to retain some level of control and say-so, is often eminently important.

The escrow agreement can even provide for how the assets are to be invested. The elder might want to tie the escrow agent to a certain investment or course of investments. For example, a client may wish his or her monies to be invested in a private or commercial annuity that makes payments to mirror a payment schedule mapped out in the escrow agreement. A client may wish for monies to be invested in rental real estate, treasury notes, bonds, etc. With the escrow agreement, so long as all parties agree, the choice can be the elder's.

These choices expressed by the elder are not precatory but contractual. Ordinarily, if a lump-sum transfer is made, the transferor can do whatever the transferor wants to do with the assets. Without controls, the transferred funds could be invested conservatively or they could be invested at the race track. The escrow agreement provides a legally enforceable method of controlling the nature of the investments and who should be in charge.

The "who" in the escrow agreement should be a financial services provider that has the following characteristics: (1) a proven track-record of prudent investments; (2) knowledge of

public benefits; (3) infrastructure to support distributions, accountings and the ability to promptly answer calls from a party to the transaction and (4) has experience with courts and agency determinations. It is best to select an entity with resources should something go wrong. It is best not to select an attorney as the attorney's malpractice carrier will likely not accept liability for this non-legal service and, even if coverage exists, most law offices are not set up to provide the above-described services efficiently. Some attorneys may attempt to serve in this capacity but should not do so without first securing coverage and establishing the systems necessary to perform the above-described responsibilities. It is best not to select a relative because relatives also have no liability coverage and are often too close to the transaction for the comfort of courts and government oversight. Among the biggest reasons for Counselor's Capital Financial Services, LLP to be created by the author and others was to allow for an affordable and reliable option as escrow agent. Counselor's Capital continues in this role to the present day.

Tax Advantages

There may be tax advantages to using an escrow agreement. First, it should be said that THE AUTHOR IS NOT A TAX ADVISOR AND IS NOT QUALIFIED TO RENDER TAX ADVICE. A TAX PROFESSIONAL SHOULD BE CONSULTED. Was that said loud enough?

With that caveat, let it be noted that without an escrow, the care provider of a personal service contract may have a sizeable income tax liability when receiving a lump-sum payment. If, for example, the care provider receives a lump-sum payment of $100,000.00, that money, added to any other income the care provider earns, is taxable in one calender year. Even though the care services are provided over time and perhaps over many years, the money is received up-front and is therefore taxable as received.

The up-front payment for the personal service contract may push the care provider into a higher income tax bracket than would have been the case if payments were made over time. With the escrow agreement, payments to the provider are made over time. Since the payments are received by the provider over time, the taxes may also be paid over time. Rather than the care provider having to pay taxes on the full contract amount in one tax year, the income is reported over more than one tax year. For a contract where care is provided over more than one calender year, this has the possibly significant advantage of deferring the payment of taxes <u>and</u> possibly reducing the overall tax by keeping the care provider's total income below tax bracket increases.

The escrow account is a separate entity for tax purposes. The account would have its own EIN number and the Escrow Agent would be responsible for the payment of taxes. The escrow agent is not taxed on the funds as earned- income-received but instead pays tax on any interest, dividends or gains.

Escrows in Guardianship Proceedings

Ellsworth Toohey has served as the court-appointed guardian of Howard Rourk for two years. Howard is in an assisted living facility and going through his modest assets to the tune of $6,000.00 per month. There is now only $35,000.00 remaining and Howard could easily live

another twenty years. In less than six months, the money will be gone. Ellsworth will have another *pro bono* guardianship case if he can afford it and Ellsworth will have to find a lawyer willing to work for no fee. Meanwhile, the ALF continues to receive its rack rate and will then receive Medicaid funds in addition to all (but $35.00) of Howard's social security. Ellsworth petitions the guardianship judge to authorize the creation of a lifetime care agreement. Under the terms of the proposed contract, Ellsworth gets the $35,000.00 in exchange for his promise to provide ongoing guardianship services to Howard for the rest of Howard's life. Even with the $35,000.00 Ellsworth will most likely work for years without pay but at least this will be something.

The Judge hears from the attorney and says, "You want me to do WHAT?!" The Judge may have high regard for the guardian and the attorney but may rightly ask what security there is for the ward. Judges have, under similar circumstances, understandably questioned what should happen if the guardian moves away, gets ill or dies.

With a well-drafted escrow arrangement, the judge's concerns may be largely alleviated. As stated *supra*, the escrow agreement can provide for what should happen if the care provider, the guardian in this case, fails to perform. More importantly to the judge, the escrow agreement also prevents the guardian from getting all of the money up-front.

Escrow agreements can be used to support personal service contracts with people other than the guardian. For example, the guardian may petition the court for authorization to enter into a personal service contract with a home health aide, an agency, a relative or a friend of the ward. Whether the agreement is with the guardian or with another person or entity, the judge may be concerned about conflicts of interest and may therefore appoint an *ad litem* to make sure the transaction is in the best interest of the ward. Whatever the result though, the escrow agreement brings a higher level of security to the personal service contract and is therefore well received by guardianship courts.

This level of comfort need not only apply to personal service contracts. Some judges authorize guardians to make gifts of the ward's assets for Medicaid planning purposes. An escrow agreement brings more security to gifting transactions as well.

The Ability to Bond and Insure Transferred Assets

An escrow agent may be bonded and/or insured. Since an escrow agent acts as a fiduciary, a fiduciary bond may be secured. Some escrow agents may have insurance that will cover loss to funds in escrow if something is done wrong. Remember that a bond does not normally protect against negligence in investing or any other negligence. Most bonds only protect against the bondholder's running off with the money.

Medicaid Transfer and Asset Considerations

Transfers in escrow inherit the characteristics of the underlying transactions. If, for example, a transfer of assets is made in exchange for a lifetime care agreement; so long as the

care agreement transaction with the care provider would have been a fair market value transaction, then the transfer to the escrow agent is also a fair market value transaction. This might seem odd in that the care provider is providing the service but the escrow agent is not; one might therefore consider that the transfer to the escrow agent is uncompensated but this would be wrong. The escrow agent is, in fact, a party to the agreement and the agreement itself provides that the monies are being transferred for the benefit of the care provider (or successors) and in exchange for the services. If no period of ineligibility would be imposed for the underlying transfer, then no period of ineligibility attaches to the transfer in escrow.

Advantages to Escrows

- Transferee cannot run off with the money.
- The transferred assets can be professionally managed.
- May significantly reduce income tax liability by spreading payments out over time.
- More likely to earn court approval (and comfort) for transfers.
- Transferred funds may be bonded or insured.

Likewise, if the underlying transfer would have resulted in a gift penalty, so too would the transfer to the escrow agent. If, for example, a gift of $50,000.00 was made for the sole benefit of the elder's granddaughter, a period of ineligibility would be imposed. If the same gift was transferred in escrow for the benefit of the granddaughter, the same period of ineligibility would be imposed. <u>The escrow agreement is therefore "penalty neutral" for transfer analysis.</u>

For transfers made prior to the effective date of the Deficit Reduction Act (DRA) of 2005[3], the Medicaid look-back period might extend from 3 years to 5 years when using as escrow agreement. For transfers in escrow made after the DRA effective date, the fact of escrow should be irrelevant as all transfers are thereafter treated to a five-year look-back. Whether a pre-DRA transfer would be treated differently if it were made in escrow has not yet been an issue for the author in his use of the agreements but the government could arguably impose a 5-year look-back period to transfers made in escrow. The escrow agreement has some of the characteristics of a self-settled irrevocable trust. The government could analogize the escrow agreement to an irrevocable trust agreement and apply the 5-year look-back. This point is arguable at best. There are important distinctions between escrow agreements and trust agreements, not the least of which is that the escrow agreement is not self-settled. In any event, it does not matter whether it is a 3-year look-back or a 5-year look-back if the period of ineligibility is controlled through fair market value transactions or staged gifts.

[3]The federal statute claims an effective date of February 8, 2006 but states may apply their own eligibility determinations differently.

Separate from the issue of whether the transfer is met with a period of ineligibility is the issue of whether the escrow account can itself be counted as an asset for Medicaid eligibility purposes. So long as the agreement is properly drafted, the escrow account cannot be counted as an asset.

The monies in the account are not owned by the applicant. Applicant has no ownership interest in the account and no access to the monies. Once the monies are transferred by the elder, they are inaccessible by the elder. For most Medicaid offices, so long as this fact is crystal clear in the escrow agreement, the government will understand that the escrow account should not be counted as an asset. This is where careful drafting becomes paramount.

Drafting the Escrow Agreement

The escrow agreement need not be very complicated. The escrow agreement must, however, attend to certain issues: (1) lack of access by the applicant; (2) access by intended recipient; and (3) choice of escrow agent. Attached to these materials is a sample of an escrow agreement drafted by the author in the context of a lifetime care agreement. The agreement should be adapted as necessary based on the nature of the transaction (i.e., gifting, lifetime care agreement, etc.).

Eligibility Determinations

The author has used the escrow agreement successfully and other of the author's colleagues have used it successfully. As of the writing of this article, the author is unaware of any denials of Medicaid eligibility based on the use of an escrow agreement done in the form supplied with these materials. Having said all of that, prior eligibility determinations are not necessarily indicative of future determinations. Medicaid rules and laws are not black and white and there is no specific rule that discusses escrow agreements in this context. State rules and laws vary. Laws change. Customs even within a state may vary from office to office and sometimes among caseworkers within the same office. Before relying on this article to advise a client, check on your rules, laws and customs. That is the proverbial but necessary "CYA" language but what is also true is that an escrow agreement should not change anything in the determination process. If the underlying transaction is done for fair market value, the fact that an escrow agreement is being used should not be relevant. Moreover, the funds in an escrow agreement, properly drafted and administered, are also not available to the Medicaid applicant.

Conclusion

An escrow agreement is one more tool that individual attorneys may find helpful to have in their Elder Law arsenals. Escrow agreements do not, in and of themselves, shelter assets. Escrow arrangements rely upon the underlying transaction to serve as a shelter or as the mode of transfer. With an escrow agreement, however, many benefits can be brought to the underlying transaction. There can be greater security for the assets, professional management, security against non-performance, and tax advantages. The author hopes this information will be helpful to create these enhanced protections for the reader's clients.