MEDICAID TRUSTS

Designing the Perfect Income-Only Irrevocable Trust

Careful drafting and funding of trusts can help clients qualify for Medicaid benefits and continue to make use of trust assets.

Author: LEO J. CUSHING and TODD E. LUTSKY

LEO J. CUSHING, CPA, LL.M, and TODD E. LUTSKY, LL.M, are attorneys at Cushing & Dolan, P.C., in Waltham, Massachusetts. ***Copyright ©2016, Leo J. Cushing and Todd E. Lutsky.***

The biggest question on the minds of elder law attorneys these days is whether to use Medicaid irrevocable income-only trusts as a planning tool. It is no secret that across the country these trusts are being challenged by the states more than ever. That being said, a recent series of cases and developments acknowledge that these type of trusts are an acceptable planning tool to protect assets from the costs of long-term care, provided however; that they are carefully drafted so as not to violate the federal or state laws governing these trusts. The balance of this article explains the important paragraphs to use as well as the paragraphs to avoid when drafting these trusts, along with income, gift, and estate tax “do's and don'ts” when operating them during the donor's life.

References to state developments in this article frequently cite Massachusetts, as that is the state in which the authors practice. Readers should consider how the laws of their jurisdictions may differ when implementing the planning ideas.

Important language for irrevocable trusts

Surviving spouse, Mrs. Public, established an income-only irrevocable Medicaid trust in 2007, naming two of her children as trustees. (Very similar terms would apply for a married couple, with the only difference being that income would be payable to both the donor and the donor's spouse, and a marital and by-pass share might be built in on the death of the first spouse in order to reduce or eliminate, if possible, state and federal estate tax.) The trust provides as follows:

(1) For so long as Mrs. Public is alive, income from the trust is payable to her.

(2) Under no circumstances is the trustee permitted to pay to or use principal for Mrs. Public's benefit.

(3) The trustee, in its discretion, may pay principal to or for the benefit of the class consisting of Mrs. Public's children of all generations.

(4) Mrs. Public reserved, in the trust instrument, the right to appoint principal or income to or for the benefit of charities of her choosing during her life. This is known as a limited power of appointment and is what makes the trust a grantor trust for income tax purposes.

(5) Upon Mrs. Public's death, the property in the trust will be paid over to those persons selected from the class consisting of her issue and nongovernmental charities, in equal or unequal amounts, as designated in a Last Will and Testament referring to this power executed after the execution of the trust. This is known as a testamentary power of appointment.

(6) In the event the power is not exercised, the property shall be sold and the proceeds added to the balance of the trust assets and all trust assets to be divided into as many equal shares as there are children then living or children then deceased leaving children then living. In the case of a share allocated to a child, such share will be paid out and distributed free of all trusts. In the event a child died, that child's share would be held in trust for that child's children rather than that child's spouse and such share will be held in trust for the benefit of those grandchildren until no such grandchild is under 30 years of age.

Planning note. Assets may be left to family members in many different ways. The method selected is generally based on the particular family situation. For example, a continuing spendthrift discretionary trust can divorce-proof the trust and provide generation-skipping tax benefits.[1]

Federal regulations regarding trusts

These trust cases generally revolve around the interpretation of the language of various trust provisions involved and the applicable regulations. Medicaid is a federal law implemented by the states. Below are the federal regulations (after 1993) governing the treatment of trusts, which may vary slightly when adopted by the various states but cannot be adopted in a way that is more restrictive than these federal regulations.

Federal law at 42 USC §1396p42 USC §1396p provides:

(d) Treatment of Trust amounts

(1) For purposes of determining an individual's eligibility for, or amount of, benefits under a State plan under this subchapter, subject to paragraph (4), the rules specified in paragraph (3) shall apply to a Trust established by such individual.

(2)(A) 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 any of the following individuals established such trust other than by will:

(i) The individual.

(ii) The individual's spouse.

(iii) A person, including a court or administrative body, with legal authority to act in place of or on behalf of the individual or the individual's spouse.

(iv) A person, including any court or administrative body, acting at the direction or upon the request of the individual or the individual's spouse.

(B) In the case of a trust the corpus of which includes assets of an individual (as determined under subparagraph (A)) and assets of any other person or persons, the provisions of this subsection shall apply to the portion of the trust attributable to the assets of the individual.

(C) Subject to paragraph (4), this subsection shall apply without regard to—

(i) the purposes for which a trust is established,

(ii) whether the trustees have or exercise any discretion under the trust,

(iii) any restrictions on when or whether distributions may be made from the trust, or

(iv) any restrictions on the use of distributions from the trust.

(3) (A) In the case of a revocable trust—

(i) the corpus of the trust shall be considered resources available to the individual,

(ii) payments from the trust to or for the benefit of the individual shall be considered income of the individual, and

(iii) any other payments from the trust shall be considered assets disposed of by the individual for purposes of subsection (c) of this section.

(B) In the case of an irrevocable trust

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

(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) of this section; and

(ii) any portion of the trust from which, or any income on the corpus from which, no payment could under any circumstances be made to the individual shall be considered, as of the date of establishment of the trust (or, if later, the date on which payment to the individual was foreclosed) to be assets disposed by the individual for purposes of subsection (c) of this section, and the value of the trust shall be determined for purposes of such subsection by including the amount of any payments made from such portion of the trust after such date. [Emphasis added.]

Problematic trust provisions

The current status of problematic trust provisions is discussed below.

Purposes clauses. These are paragraphs that indicate that the trust is designed for a reason, such as to provide for the donor to have as complete a life as possible and to ensure that the donor's assets in the trust are to be used to keep the donor in the community as long as possible. This type of language could cause the assets in the trust to be countable for Medicaid purposes.

The standard to determine if an asset is countable for Medicaid purposes is if there are *any circumstances*, regardless of how remote, that principal of the trust can be paid to the donor then it must be paid and will be considered countable. Clauses like this one make it appear that principal is available and thus may result in a denial for Medicaid benefits. While this clause alone may not cause the trust assets to be countable, it nevertheless should not be a part of a Medicaid irrevocable trust.[2]

Termination clauses. These are clauses placed in the trust that generally allow the trustee under certain circumstances to terminate the trust and distribute the assets out to the beneficiaries. The problems with this type of language is that if all the trust assets can be distributed to the beneficiaries and there is no distinction made between the income and principal beneficiaries, and the donor is generally an income beneficiary, the court will assume that the principal could be distributed to the donor of the trust, thus making the assets countable for Medicaid purposes. Again, if the principal can be paid to the donor under *any circumstance,* then it must be paid and will make the assets of the trust countable.[3]

Trigger language. This language was popular before 1993, but these trusts still exist and were not grandfathered by the 1993 Medicaid legislation. This language generally states that during any period that the donor of the trust is not eligible for Medicaid benefits, the trustee in its discretion can distribute principal to the donor for his or her care or for health and medical expenses including nursing home care, etc. Even though the trust may have stated that the trustee cannot distribute principal to the donor in any other paragraph, the state will deny the donor Medicaid benefits because by not being eligible, the principal of the trust can be paid out to that individual.

This is certainly language that should not be placed in a Medicaid irrevocable trust if the donor wants to add certainty to the protection of his or her assets. More troubling are trusts drafted under prior law

that included triggering language, as they were not grandfathered once the updated law was passed.[4]

Silence as to the distribution of principal. Sometimes a trust is drafted to state that income can be distributed to the donor during the donor's lifetime, but the trust fails to mention whether principal can be distributed out to the donor. This is likely to cause the state to take a closer look at the trust and then end up denying Medicaid benefits.

In a recent fair hearing on this very matter, the state was successful in denying the applicant Medicaid benefits, which resulted in the trust assets being countable and at risk for nursing home costs. The state indicated that under the Uniform Trust Code, and coupled with the other broad trustee powers that the trust contained, if the trust does not prohibit the trustee from taking an action then that action can be taken. In this case, the trust did not specifically prohibit the distribution of principal, so it was determined that principal could be distributed.[5]

The prudent form of trust drafting must include a paragraph that specifically prohibits the distribution of principal to the donor or the donor's spouse under any circumstances. In fact, this may be the single most important paragraph in the trust.

Trustee's power to lend money to a beneficiary. This type of paragraph can usually be found in the trustee power section of the trust. It might generally state that the trustee has the power to lend money to the beneficiary when and if reasonably necessary and with or without interest or security. The real problem with this is that the donor of the trust is likely an income beneficiary and because the power granted to the trustee allows him or her to lend money to any beneficiary, the state will determine that there is a circumstance in which principal can be distributed to the donor. Therefore, the trust assets will be countable and at risk for nursing home costs.

It is okay for the trustee to have the power to lend money but just not to the donor. It would be prudent to make sure an irrevocable income-only trust has a paragraph that specifically prohibits the trustee from lending money to the donor or creator of the trust.[6]

Right to redefine principal as income in a reasonable manner. The Uniform Principal and Income Act (UPIA) was designed to allow the trustee to allocate principal from investments to income so as not to limit investing options that may harm the income beneficiaries or vice versa. This way the trustee would not be forced to invest in only income-producing assets to help the income beneficiary while potentially hurting the principal or remainder beneficiaries and, again, vice versa. The state has successfully persuaded hearing officers and Superior Court judges that this power permitted a distribution of principal to the donor.

The solution to this problem would be to put in the trustee power section of the trust a paragraph that states, notwithstanding the Massachusetts Uniform Principal and Income Act, the trustee shall have no power to allocate principal to income. Fortunately, this may not be necessary, because of *Heyn* v.

Director of Office of Medicaid.[7] In *Heyn*, the court held that the power to allocate between income and principal did not cause the assets to be countable.[8]

Right to use and occupy real estate. In many of these trusts, the donor is given the right to use and occupy the home during the donor's life. The state has argued that this power makes the home or other real estate “available” for the donor and thus a countable asset and at risk for the costs of nursing home care. The rules governing these trusts indicate, however, that only trust assets that are payable to the donor can be countable or at risk for the nursing home costs. The state is challenging this type of language in trusts and so the solution is to simply make sure the trust does not have any such language.

In *Doherty*, the applicant did not retain a life estate but had the right to use and occupy by the house by the terms of the trust. This was one of the reasons the trust asset—i.e., the house—was countable.[9] In Fair Hearing No. 1200356, the hearing officer agreed with the authors' argument that the right to reside under the trust terms was akin to a life estate, and such a provision did not make the asset countable.

Right of substitution. This is generally a power that is put in that allows the donor the right to withdraw all of the trust assets as long as they are replaced with assets of the same value. This is a power that is used to make the trust a grantor trust for income tax purposes.[10] This is what would allow all of the trust income and capital gains to be reported on the donor's personal income tax return so that he or she continues to pay the income tax at the donor's lower rates just like before the trust was established. However, the state will interpret this to mean that the assets of the trust can be paid out to the donor, thus considered countable assets.

The solution to this problem is simply not to use this power in the trust document. The same favorable income tax benefits can be achieved by using a limited power of appointment, which allows the donor to appoint the income and principal to charities during his or her life, as mentioned above.[11]

Right to pay the donor's estate tax, estate administration costs, and costs associated with last illness. In these cases, the trustee granted the right to pay for any estate taxes due following the donor's death or all costs associated with his or her last illness or as needed to close out the estate. The problem with this power is that these expenses are generally large and would likely cause the trustee to be using principal of the trust for the benefit of the donor. Any time principal can be used for the benefit of the donor makes the trust assets countable.

Furthermore, there are cases that state the cost of the nursing home was a cost associated with the donor's last illness. This allows the state's estate recovery unit to force the access of trust principal to pay the bill. Thus, even if qualified for Medicaid benefits, the trust assets would be at risk for estate recovery purpose. This type of paragraph should not be a part of the trust.[12]

Compensation of trustees. In cases where the donor of the trust is also the trustee, MassHealth may argue that the power of the trustee to compensate himself or herself permits the distribution of principal to the donor. Of course, this analysis ignores the fiduciary principles of a trustee, as recounted in *Heyn* and *Doherty*. However, in Fair Hearing No. 16018677 and Fair Hearing No. 1509433, the fair hearing officer determined that the payment of trustee compensation to the donor, who was serving as trustee, was not a distribution of principal. Thus, it did not make a trust asset countable in a MassHealth eligibility determination. Nevertheless, best practice is to appoint a person other than the donor as trustee. [13]

Limited powers of appointment. Donors may reserve a limited power of appointment to the donor to appoint under the trust. MassHealth has argued that this limited power causes the assets to be countable, as the donor could appoint the assets to the beneficiary, who in turn could return the assets to the donor. The *Heyn* court rejected the analysis, as the assets of family members (other than the spouse) are not considered when making eligibility determinations.[14]

Pooled trusts as charities. MassHealth sometimes argues that the power to appoint to a charity runs afoul of the any circumstances test. Per MassHealth's argument, such a provision allows the donor to appoint to a pooled trust, which is a type of trust managed by a nonprofit organization that allows for certain payments back to the donor of the pooled trust. After the donor's death, the pooled trust must pay back the state, then between 10% and 20% goes to the sponsoring charity, and finally the balance is distributed to the family. This argument fails because the pooled trust itself is not a charity, and the trust does not permit appointment to a noncharitable entity.

In Fair Hearing No. 1511164, the fair hearing officer determined that because the definition of a limited power of appointment prohibits the appointment of assets to himself or herself, then the trustee could not appoint to a pooled trust because the pooled trust benefits the powerholder (i.e., the applicant). Therefore, the state's argument to appoint to a pooled trust fails, and the assets in the irrevocable trust were deemed noncountable in the Medicaid eligibility determination. In Fair Hearing No. 1604346, the fair hearing officer also indicated that this limited power of appointment to a pooled trust did not cause the assets in the trust to be countable in a Medicaid eligibility determination.

Using these trusts

By using the drafting tips discussed above, attorneys can better protect their clients' interests when creating Medicaid irrevocable income-only trusts. To which clients should these trusts be recommended, and how do these irrevocable income-only trusts operate? Those and other practical issues are discussed, in question-and-answer format, below.

Question. Who should consider using these Medicaid irrevocable trusts?

Answer. While no hard-and-fast rule restricts who can use these trusts, they are generally recommended to folks who are age 60 or older. In addition, these irrevocable trusts should be

considered if one of the objectives in the estate and elder law planning world is to protect assets from the cost of long-term care. In the event this type of asset protection planning is not important to the client, then a revocable trust would be the recommended vehicle for estate planning needs. Finally, clients who are under age 60 but have a diagnosed mobility-related illness should, of course, consider the use of these irrevocable trusts as well.

Question. Who can be the donor of these irrevocable trusts and what does that mean?

Answer. The donor is referred to as the individual who creates the trust. The donor may also retain certain powers over the trust—most importantly, the power to remove and replace a trustee at any time for any reason, provided, however, that the replacement trustee can never be the donor of the trust. This retained power by the donor allows the donor to retain a significant degree of control over the operation of the trust, even though the donor does not serve as trustee. In addition, the donor will also be an income beneficiary of the trust.

Question. Who can be the trustee of these irrevocable trusts?

Answer. Often, the donor would like to serve as trustee of the trust, thereby significantly increasing the donor's control over the operation of the trust assets during the donor's life. There is support for this position in Massachusetts; in *Ledger* v. *Department of Medical Assistance*,[15] the court indicated that, while this may appear to be an unappetizing maneuver, it nonetheless fails to contravene any rule or regulation. However, there has since been another case known as the *Doherty*[16] case in which the appellate court in Massachusetts indicated that the irrevocable trust was not drafted properly and provided too much control to the donor, thus causing the assets of the trust to be at risk. Therefore, the donor should not serve as trustee, and the trust itself should prohibit the donor from serving as trustee.

Question. Do these trusts avoid the costs associated with the probate process?

Answer. An individual who passes away and owned assets in his or her own name, without a designated beneficiary, will subject all of those assets to the costs associated with the probate process. Establishing this irrevocable trust and, most importantly, funding the trust with assets, enables the assets that have been retitled to the name of the irrevocable trust to avoid the costs associated with the probate process.

Bear in mind that individuals who have just a will need to file that one document with the probate court. If this is all the planning that was done, there is a good chance of not even avoiding probate. Finally, a will by itself will not help an individual reduce estate tax liability.

Question. Do these irrevocable trusts protect assets from the costs of long-term care and how long does it take?

Answer. Once assets have been transferred to these properly drafted Medicaid irrevocable trusts, the assets will be protected from the costs of long-term care after the expiration of five years from the date of transfer. This is known as a five-year lookback period for Medicaid eligibility purposes. This means that, from the date in which an individual would apply for Medicaid benefits, the state is entitled to look back at all of his or her prior transactions, bank accounts, investment accounts, etc., for the previous five years in order to see if there were any disqualifying transfers made during that period which would in fact prevent the individual from being eligible for Medicaid benefits.

A disqualifying transfer is when a formerly available asset is transferred for less than fair market value to a place where it is no longer available for the nursing home. This same five-year waiting period applies even if the assets are just given to children and not to a trust. Once the donor has successfully made it beyond five years from the date of transfer to the trust, the state would then no longer be able to see such a transfer and, therefore, it would be protected from the costs of long-term care.

Potential legislative change. This five-year lookback period is under review, and the federal government is constantly exploring the idea of expanding it to be a ten-year lookback period.

Question. Which type of assets should a person retitle or transfer into one of these irrevocable Medicaid trusts?

Answer. First and foremost, IRA assets or any other qualified plan asset or retirement type asset, such as a 401(k) plan or a 403(b), should not and, in fact, cannot be transferred into these irrevocable trusts during life. In order to transfer one of these qualified plan assets into the trust, the donor would first need to withdraw the money from the qualified plan, thereby subjecting it to ordinary income tax liability and transferring only the amount net of taxes to the trust. Generally, this makes funding an irrevocable trust with such assets cost-prohibitive.

The donor should use assets from qualified plans for living expenses before looking to the trust assets for that purpose because the retirement plan assets would be outside the trust and, therefore, at risk for the costs associated with long-term care.

A common asset that folks like to transfer to the trust would be their primary residence. It is also possible to transfer rental property or vacation property to these irrevocable trusts in order to protect them from the costs of long-term care.

Finally, people also wish to transfer their nonqualified investment portfolios or a portion of their investment portfolios to these irrevocable trusts in order to protect them from the costs of long-term care. All of those types of assets can, in fact, be transferred to the irrevocable trust without any adverse income or gift tax consequences.

Question. Can the donor continue to live in his or her home after it has been transferred to one of these Medicaid irrevocable trusts?

Answer. Yes, and no special language is needed in the trust stating that the donor is permitted to live there the rest of his or her life or to use and occupy the property. To ensure the donor has this right, consider having the donor retain a legal life estate in the deed transferring the property to the trust.[17] This will give the donor the right to live there, among other things, for the rest of his or her life. If the trustee tried to sell the home, he or she would now need the donor's signature. Plus, the donor may retain the right to remove the trustee. The donor is in control of the house.

Question. Can the home be sold after it has been transferred to one of these Medicaid irrevocable trusts and, if so, how does it work?

Answer. Yes, the home can be sold after it has been transferred to the irrevocable trust. Generally, the donor simply tells the trustee that the house is to be placed on the market and sold. The trustee of the irrevocable trust would sign the purchase-and-sale agreement in order to complete the transaction. Selling the property from the irrevocable trust in no way complicates the transaction nor adversely affects the buyer. Upon completion of the transaction, the buyer would cut a check made payable to the trustee of the irrevocable trust who then would, in turn, deposit the check into a bank account that is established in the name of the irrevocable trust.

The donor should not receive the money personally, but instead the money should be transferred directly into the irrevocable trust bank account so as not to restart the five-year waiting period. Finally, the house can be sold any time after it is transferred to the trust, even if it is during the initial five-year period from the date of transfer.

Question. Does the sale of a home from the irrevocable trust re-set the Medicaid five-year lookback period?

Answer. The five-year lookback period is unaffected and, in fact, not reset by the selling of a home from the irrevocable trust, because nothing new was placed into the trust. The five-year lookback period starts to run on the day an asset was transferred from an individual's own name into the irrevocable trust and not the day the trust sells the property.

For example, if the donor establishes an irrevocable trust and transfers the property into the trust on 1/1/2011, and then, on 1/1/2013, the trustee of the trust sells the property and in exchange the trust receives the proceeds, which are promptly deposited into the irrevocable trust bank account, that transaction will have no impact on the initial five-year waiting period that began on 1/1/2011, when the home was transferred to the irrevocable trust.

In other words, the proceeds from the sale of the home, which are now deposited in the trust, will be protected from the cost of long-term care in three more years, which represents the balance of the number of years remaining from the initial transfer of the home to the trust on 1/1/2011. Again, since nothing new was placed into the trust, there is no new five-year waiting period created. In this case,

the trustee simply reinvested the assets that were already inside the trust from real estate to cash or any other investment of the donor's choosing.

Question. Can the trustee of the trust use the proceeds from the sale of a previous home to purchase a new home inside the trust?

Answer. Once the proceeds from the sale of the home are received by the irrevocable trust and are deposited into the trust bank account, the trustee may invest those assets in any manner the trustee deems fit. In other words, the trustee may simply write a check to the seller of a home that the donor is interested in purchasing, and the seller will prepare a deed transferring the property to the trustee of the irrevocable trust. Once again, this transaction of purchasing the home inside the irrevocable trust does not reset the five-year waiting period.

As a practical matter, when one spouse passes away, it is not uncommon for a surviving spouse to downsize and sell the old primary residence and convert it to a condominium or some other downsized home. This transaction is completely permissible within the terms of the trust and again would not reset the five-year waiting period for Medicaid eligibility purposes.

Question. Does the donor need the permission or his or her children (as trust beneficiaries) in order to buy or sell real estate after the home has been transferred to the Medicaid irrevocable trust?

Answer. No. The donor of the trust can simply instruct the trustee to place the home on the market for sale or to purchase a new home following the sale of the previous home. In the event the trustee does not comply, the donor of the trust has retained the ability to remove and replace the trustee at any time and would thereby simply remove the trustee and put in a trustee who is willing to complete the requested transaction. Therefore, the donor does not technically need the children's permission to complete the purchase or sale of a new home after it has been transferred to the irrevocable trust.

Question. Will the donor still receive the capital gains tax exclusion upon the sale of his or her primary residence after it has been placed into an irrevocable Medicaid trust?

Answer. Yes. The IRC Section 121 capital gains tax exclusion enables married people to shelter the first $500,000 of capital gains on the sale of their primary residence (the first $250,000 of capital gains for single individuals). The rule simply states that the donors must have owned and used the property as his or her primary residence for two of the last five years in order to take advantage of this capital gains tax exclusion upon the sale of the property. Because the trust is designed as a grantor trust for income tax purposes, the individuals transferring the property to the trust will not lose their ability to take advantage of this capital gains exclusion once the property is sold from the trust.

The term “grantor trust” means that the donors, or creators of the trust, are considered the owner of the trust for all income tax purposes and, therefore, will be eligible to maintain their capital gains tax exclusion on the sale of the property from the trust. The trust is a grantor trust because the donor has retained the ability to direct where the principal or income of the trust can go during the donor's

lifetime. In accordance with Section 674(a), this retained power is what makes the trust a grantor trust for income tax purposes, thereby preserving the capital gains tax exclusion.

Question. Can a donor transfer rental property into one of these Medicaid irrevocable trusts and, if so, what are the tax and operating implications?

Answer. Rental property can be transferred to these irrevocable trusts without adverse tax implications of doing so. Remember, like the primary residence, this rental property can be sold and the proceeds can in fact be used to purchase another piece of property at any time during or after the five-year lookback period. There would also be no adverse income tax consequences associated with any such sale. In other words, the donor would continue to pay all of the same capital gains taxes associated with the sale of rental property out of the trust as the donor would have if he or she had sold the property while it was in his or her own name, because (as mentioned above) the trust is a grantor trust.

In addition, the donor would retain the ability to pay the bills associated with the rental property, make decisions regarding rental increases, make decisions regarding removal of existing tenants, and continue to collect and use the rent as usual. Remember, these were all decisions that were made by the donor prior to transferring the property to the trust.

Question. After rental property has been transferred to a Medicaid irrevocable trust, how is the rental income generally handled, and who receives it?

Answer. These Medicaid irrevocable trusts are designed as income-only trusts, which means that the trustee is obligated to pay out the income earned by the trust to the donor. Rent, of course, is income. In this regard, the tenant would write a check for the rent and make it payable to the trustee of the irrevocable trust. The trustee of the irrevocable trust must have established a checking account in the name of the irrevocable trust under its own tax identification number in order to deposit this rent check into the trust checking account. The rent check represents trust rental income for which the trustee is then obligated to write a check out of the trust checking account payable to the donor of the trust, who in turn will deposit that check into his or her own personal checking account.

The donor can also set the trust account up in a way that will automatically transfer the rental deposits to the donor's personal checking account to be used as desired. In that situation, the trustee does not need to be involved in these transactions.

In other words, the rental income will end up in the donor's personal checking account through this two-step approach instead of directly, which is where the rental income used to go prior to the rental property being transferred to the irrevocable trust. The donor is then free to spend that rental income on anything he or she desires, just like before the establishment of the trust.

From a liability perspective, it may be advantageous to transfer rental properties into LLCs. In the event that a tenant or guest is injured in the rental properties, the existence of the LLC will help protect

the donor's personal assets from being taken in satisfaction of a legal judgment against him or her.

Question. Do these Medicaid irrevocable trusts have to file separate income tax returns and, if so, does that result in an increased income tax liability?

Answer. These trusts are considered grantor trusts and should file an income tax return, but all the elements of income, deductions, credits, and the like should also be reported on the grantor's return. It is also important that the trust obtain a separate tax identification number for this purpose. In addition, having this separate tax identification number also helps maintain the integrity of the trust for Medicaid eligibility purposes. However, because the trust is a wholly owned grantor trust for income tax purposes, as described above, the trust will effectively not pay any separate federal income taxes. Instead, this grantor trust status causes the donor to be treated as the owner for income tax purposes and essentially flows the income through the trust and causes it to be reported on the individual donor's income tax return, Form 1040, just as was done prior to the establishment of this irrevocable trust.

Therefore, these Medicaid irrevocable trusts are known to be income tax neutral, resulting in no increase or decrease in income tax liability to the donor. The donor will continue to pay the same tax as he or she did prior to the establishment of the irrevocable trust.

Question. Do the trust assets receive a step-up in basis for capital gains tax purposes upon the death of the donor?

Answer. Yes, the assets will get a full step-up in basis on the death of the donor due to the fact that the donor retained the right to the income in accordance with Section 2036. This will cause the assets to be included in the estate of the donor, thereby receiving the step-up in basis under Section 1014.

This step-up in basis rule can be important in reducing future capital gains tax liability associated with the sale of the property following the death of the donor. A step-up in basis means that the cost basis in the hands of the beneficiaries following the death of the donor would be equal to the fair market value of the asset received as of the date of the donor's death. Therefore, if the beneficiaries of the asset were to sell it shortly after the donor's death, it would result in little to no capital gains tax liability to the beneficiaries.

For example, if the donor of the trust had purchased the home long ago for $50,000 and had approximately $50,000 of capital improvements during the donor's lifetime, that would result in the donor's cost basis of the property being equal to $100,000. Assume the donor transferred this property to an irrevocable Medicaid trust and upon the donor's death the property was worth $400,000. Upon the death of the donor, the beneficiary of this property would receive a cost basis equal to its fair market value of $400,000. If the beneficiary then sold the property for approximately $400,000, which would be the fair market value, there would be no capital gains tax to be paid by the beneficiary.

This should be contrasted with individuals who opt to give away their home or other highly appreciated rental property to their children prior to their demise. Such a transaction would result in a carryover basis in the hands of the donee/beneficiary. A carryover basis means that the donee/beneficiary of the property transferred during life would have the same basis as the donor immediately prior to the transfer.

In the example, that would mean that the donee/beneficiary, the child, would have a cost basis in this real estate equal to $100,000. In the event the donee/beneficiary sold the property following the death of the donor, the capital gain would be $300,000 ($400,000 - $100,000). Assuming at 20% federal capital gains tax rate, a 5% state capital gains rate, and applying the new net investment income tax rate of 3.8%, the capital gains tax would be approximately $86,400. The Medicaid irrevocable trust's ability to conserve this step-up in basis benefit is extremely important. This basis step-up would apply to not only real estate, but any investment portfolios or stocks transferred to the trust that may have appreciated over time.[18]

Question. Is a gift tax liability associated with transferring significant wealth into these Medicaid irrevocable trusts?

Answer. No gift tax liabilities are associated with transferring assets to these irrevocable trusts because the gifts to these trusts are known as incomplete gifts for gift tax purposes because the donor retains the right to designate the final beneficiaries of the trust in accordance with Reg. 25.2511-2(c).[19] In addition, no gift tax returns are required to be filed to report the transfer to the trusts, except if the donor wishes to disclose the transfer to commence the running of a statute of limitations for auditing the gift.[20]

A gift tax return should probably be filed, if only to provide full disclosure. If the donor included a provision in the trust rendering the gift incomplete, the regulations provide that a gift should be disclosed on a gift tax return, but a failure to file would not render the taxpayer subject to any penalties or gift tax. In most cases, no gift tax return would have been filed. The risk is that the transfer was not incomplete and gift tax would have been due, giving rise to penalties. Under Reg. 25.6019-3(a), “[i]f a Donor contends that his retained power over property renders the gift incomplete and hence not subject to the tax as of the calendar quarter or calendar year of the initial transfer, the transaction should be disclosed in the return for the calendar quarter or calendar year of the initial transfer and evidence showing all relevant facts, including the copy of the instrument of transfer, shall be submitted with the return.

Question. Does the donor have to sell his or her assets inside the donor's investment portfolio prior to transferring them into the trust?

Answer. No. In general, the funding of an irrevocable trust does not result in any income-tax-related issues whatsoever. In other words, funding the trust generally means nothing more than retitling the existing assets to the name of the trust. For instance, suppose the donor has an investment account

at Fidelity. The donor has been receiving statements from Fidelity in his or her own name, which is indicated in the upper left corner of the statement. Once this Fidelity account has been successfully retitled to the name of the irrevocable trust, the donor of the trust will continue to receive these same statements from Fidelity with all the same investments listed on them. The only difference will be that the name of the irrevocable trust along with the trustee's name will appear in the upper left corner of the statement. No adverse income tax consequences are associated with retitling assets to the trust, as nothing was sold prior to the transfer.

Question. How does a donor transfer real estate to the irrevocable Medicaid trusts, and are there any adverse income tax consequences?

Answer. The funding of a trust with real estate is generally done through the preparation of a new quitclaim deed. The deed simply transfers the property from the individual name of the donor to the name of the trustee of the irrevocable trust. The new deed and a trustee certificate are then filed at the registry of deeds. No adverse income tax consequences are associated with this transfer, nor is there any gift tax liability due.

Question. Are there any investment limitations on the trustee of a trust?

Answer. The trustee of a trust can invest in all of the same investment options that would be available to an individual. Choices are not limited by having the assets invested inside a trust. The trustee should, however, follow the prudent investment rule as a guide towards making investment decisions. The only caveat, of course, is that there are no individual retirement accounts owned inside of an irrevocable trust, as mentioned above.

Question. Can these irrevocable trusts be changed in any way after they are created and, if so, how?

Answer. While the trust is irrevocable, it nevertheless can be changed through the use of a limited power of appointment, as mentioned above. This is a power in the trust in which the donor is granted the ability to change the beneficiaries of the trust but generally is limited to a class consisting of the donor's children of all generations and charities. This power enables the donor to retain a significant degree of flexibility to adjust his or her wishes as life events unfold after the creation of the trust.

For example, a donor may wish to leave a little more assets to grandchildren or perhaps may find that one child is doing extremely well financially while another child is struggling and may desire to reallocate the percentages in which the children are to receive assets, all of which can be done through the use of exercising this limited power of appointment. The donor cannot, however, add a person as a beneficiary to the trust who was not already a member of the class of beneficiaries. The class of beneficiaries can be increased to include siblings or nieces and nephews or as needed to accommodate any family situation. Sometimes making the class larger when the trust is initially drafted may provide even greater flexibility later.

Finally, this limited power of appointment may also entitle the donor to completely eliminate any child or grandchild from receiving any benefits and thereby offers a significant degree of control in the event a child during life does not cooperate.

Question. Can the donor add assets to the irrevocable trust many years later?

Answer. Yes, assets can be added to the irrevocable trust at any time after the trust has been created. However, the addition of assets to the trust will result in the creation of a new five-year lookback period, but the lookback period will be associated only with those assets that were transferred. The creation of this new lookback period for those newly transferred assets will in no way affect the lookback period for previously contributed assets. In other words, if the donor had contributed assets to the trust five years earlier and only now wishes to put additional assets into the trust, the assets that were put into the trust five years earlier will remain protected from the cost of long-term care. The new lookback period will apply to only the newly added assets.

Question. Is it important to use one or two irrevocable trusts when doing this type of asset protection planning?

Answer. A donor who is single would need only one irrevocable trust. A married individual, however, with assets exceeding, for instance, $1 million for a resident of Massachusetts or Maine, $1.5 million for Rhode Island, or $2 million for someone who lives in Connecticut, or may exceed any of these state exemption amounts over the balance of his or her lifetime, should consider two irrevocable trusts. The reasoning behind two irrevocable trusts is to help the donor more fully use both of his or her federal and state estate tax exemption equivalent amounts, thereby serving to reduce estate tax liability. In other words, these Medicaid irrevocable trusts can also help the donor reduce estate tax liability while simultaneously serving to protect assets from the cost of long-term care. A discussion on the reduction of estate tax liability and how the trusts are designed to accomplish that is beyond the scope of this article.

Question. Can the donors borrow against any real estate that has been transferred to the irrevocable trust?

Answer. Once real estate has been transferred to these irrevocable trusts, the donor generally cannot borrow against the property any more. This is usually not a concern for many of the elderly folks who do this type of planning, as they have paid off their mortgages and are not interested in going into debt. In the event the donor happens to have an existing mortgage on the property but wishes to transfer it into one of these irrevocable trusts, the transfer of an existing debt to the trust will not trigger the due-on-sale clause but the donor will be prohibited from refinancing such debt. Therefore, it is important that any such encumbered property being transferred to the trust have a fixed-rate mortgage for the life of the loan.

If borrowing against the property in the future is of importance to the donor, then the donor should establish a home equity line of credit prior to transferring the property to the irrevocable trust. This will enable the donor to borrow against that equity line after the property has been transferred to the trust. Once the equity line expires, however, the donor would not be able to renew it.

Question. Can the donor receive principal from the trust?

Answer. The trustee must be prohibited from distributing principal directly to the donor, as this is the paragraph that provides the protection from the costs associated with long-term care. Generally, this is also not a problem for most of the people who use these irrevocable trusts, as they are usually living off of their income. Remember, the income, such as Social Security benefits, pensions, any interest and dividends generated from assets inside the trust, rent generated from inside the trust, or, of course, any IRA-type assets which are outside the trust, are all available to the donor after the trust is established. This flow in income generally is enough to allow the individual to continue to maintain the lifestyle he or she was used to prior to establishing the trust.

In the event extraordinary events arise and principal is needed in the future, the donors of the trust generally look to assets that were left outside of the trust to spend first (e.g., the IRA assets). Remember, these assets will remain at risk and, therefore, should be spent down prior to any assets that are in the trust which would be protected from the cost of long-term care and preserved for and used by the surviving spouse.

Question. What money would be available if a major repair is needed on the home, and where does the money come from?

Answer. The trust money can be used to maintain other trust assets. If a new bathroom or a new roof is needed on the vacation home or rental property that is owned by the trust, the trustee is permitted to use money or investments that are inside the trust in order to make these improvements. In fact it is important that such improvements are done in this manor and not paid by the donor out of personal non-trust assets as that would look like a gift is being made by the donor to the trust—which would result in a new five-year waiting period for those transferred assets. Remember, the donor does not own the real estate in the trust so he or she should not be paying for these home improvements but the trust can and should pay for them. A donor who reserved a life estate on the home can pay all bills and expenses and improvements for the house right out of his or her personal account.

Conclusion

The scrutiny of Medicaid irrevocable income-only trusts will continue. Thus, the effectiveness of these trusts will be based upon the language used in drafting them. With proper drafting, these trusts remain an acceptable planning tool for protecting assets from the cost of long-term care.

[1] See Pfannenstiehl v. Pfannenstiehl, 88 Mass. App. Ct. 121 (2015).

[2] See Cohen v. Commissioner of Div. of Medical Assistance, 423 Mass. 399 (1996); Doherty v. Dir. of Office of Medicaid, 74 Mass. App. Ct. 439 (2009).

[3] See Doherty, *supra* note 2.

[4] See *Cohen, supra* note 2.

[5] See Fair Hearing No. 1222688 (holding fiduciaries given power to distribute principal under broad powers of G.L. c. 190B, §7-401, and so silence in trust allows distributions of principal). General Laws c. 190B, §7-401, was repealed when the Massachusetts Uniform Trust Code (MUTC) was enacted. See St. 2012, c. 140, §51. However, the MUTC provides for specific powers of the trustee that are substantially similar. G.L. c. 203E, §816.

[6] See Edholm v. Minnesota Dept. of Human Services, No. 27-CV-11-23237 (Minn. App. Ct., 6/17/2013).

[7] 89 Mass. App. Ct. 312 (2016).

[8] See also G.L. c. 203D, §18(a) (creating presumption that additions to trust default to principal).

[9] Doherty, *supra* note 2.

[10] See Section 675(4)(C).

[11] See Heyn, *supra* note 7 (right of substitution does not cause trust assets to be countable).

[12] See In re Estate of Melby, 841 N.W.2d 867 (Iowa, 2014) (trust assets countable because of ability to pay expenses of donor).

[13] See Ledger v. Commissioner of Division of Medical Assistance (describing practice of donor appointing self as trustee as unappetizing maneuver).

[14] See Heyn, *supra* note 7.

[15] Note 13, *supra.*

[16] Note 2, *supra.*

[17] See Heyn, *supra* note 7.

[18] See Sections 1014 and 2036.

[19] See also Section 2511.

[20] Reg. 25.6019-3(g).

END OF DOCUMENT -

© 2017 Thomson Reuters/Tax & Accounting. All Rights Reserved.