Medicaid Income Only Trusts
<u>Prevail Against Expanded Estate Recovery Rules</u>

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Medicaid income only trusts have always had their supporters and their critics with regard to their ability to protect assets from the costs associated with long term care. The introduction of expanded estate recovery rules, have undoubtedly raised even more questions regarding the effectiveness of these trusts. There are also two schools of thought surrounding the issue of who should or should not be trustee on these trusts. First, there are those that believe the children of the family or an independent party must serve as trustee in order for the trust to be effective while others, including this author, believe that mom and dad could be not only the donors but also the trustees and still have the trust protect assets from nursing home costs. Hopefully, the balance of this article will once and for all resolve many of these outstanding issues surrounding Medicaid income only trusts and their effectiveness.

This article will walk you through a real life fact pattern that was handled by my office from the beginning stages of planning, including the application for and approval of Mass Health benefits, and finally, to the death of the client along with the estate's endeavors in dealing with the Medicaid expanded estate recovery rules that were in effect at that time. Our client's name will be Mary Public.

In late 2002, Mary had entered a long term care facility. It turned out that, in 1993, Mary had an irrevocable income only trust created into which she transferred her multi-family property and did not retain a legal life estate. A copy of the deed is attached for reference. It is important to note that a nominee realty trust was not used in this transaction as the property was deeded directly to the irrevocable income only trust, and that Mary's children served as trustee on the Medicaid irrevocable income only trust. However, it is the belief of this author that the outcome of the case would have been the same even if Mary had served as trustee on both the Medicaid irrevocable trust and a nominee realty trust, if one had been used. Support for this position comes from a case entitled <u>Gerald H. Ledger v. Commissioner of the Division of Medical Assistance</u>. In this case, husband and wife conveyed their residence to themselves as trustee of a nominee realty trust in which the Schedule of Beneficiaries listed their respective irrevocable income only trusts as beneficiaries, of which they also served as trustees. The Court concluded that although this may be regarded as an unappetizing maneuver, it nonetheless does not contravene any applicable principles or regulation.

The next step was to start the Medicaid application preparation and eligibility process for Mary. In doing so, a copy of the deed, irrevocable income only trust along with all other relevant financial information was submitted to the Department of Medical Assistance. At the end of the process, Mary was approved for Medicaid eligibility effective 12/15/2002 and a copy of the approval letter from the Department of Medical Assistance is attached for reference. This marks a mile stone for the irrevocable income only trust as it demonstrates its effectiveness in at least initially sheltering the assets from the costs associated with long term care.

On October 8, 2003, Mary passed away and the estate administration process began. The first step was to prepare a letter to the Division of Medical Assistance Estate Recovery Unit informing them of Mary's death along with providing a copy of her death certificate and stating that Mary died without a Will. Furthermore, we informed the Division of Medical Assistance that Mary had absolutely no probate assets and therefore an administration will not be filed with the Probate Court. A copy of this correspondence is enclosed for reference.

On December 17, 2003, the Division of Medical Assistance responded to our letter by submitting to us an asset disclosure form for completion and return. A copy of this letter is enclosed for reference. On January 13, 2004, a completed asset disclosure form was returned to the Department of Medical Assistance Estate Recovery Unit. Part B of the form requires that you describe the type of personal property that the decedent owned immediately prior to death, such as bank accounts, stocks, and bonds, along with a description of the form of ownership such as jointly or with the right of survivorship. In addition, the form requires that you list all real estate owned immediately prior to death as well as describe the type of ownership, be it joint owner with right of survivorship, life tenancy or as tenants by the entirety. Finally, the form asks whether or not the decedent immediately prior to death owned any trust property, which passed to a beneficiary.

In the case at hand, the decedent did have some personal property, but did not have any real estate. With regard to the trust question, mentioned above, the box should be checked "no" as our position is that the decedent does not "own" any of the property inside an irrevocable income only trust. Nevertheless, the trust was disclosed and a copy of it was provided to the Department of Medical Assistance Estate Recovery Unit. As a practice pointer, please be sure to read the question on the form closely regarding trusts prior to answering. A copy of this Department of Medical Assistance Asset Disclosure Form is enclosed for reference.

The asset in the trust was rental property worth approximately $1,000,000 as of the date of the decedent's death. A response was made to the Department of Medical Assistance's request for additional information by sending a letter dated February 20, 2004, in which provided Schedule A of the irrevocable trust as they already had a copy of the irrevocable trust which was provided during the Medicaid application process along with the necessary bank account information.

Once the Department of Medical Assistance Estate Recovery Unit reviewed these documents, The estate was informed by a telephone call that the Department of Medical Assistance Estate Recovery Unit would not be pursuing any aspects of the assets in the irrevocable income only trust and the case was closed. We did not have to obtain a release of

Medicaid lien, as there was never a lien placed on the property to begin with. Since then, the property has been successfully transferred to the family members owned in a series limited liability company for their protection, all without interference from the Department of Medical Assistance. Hopefully, this will serve to demonstrate the effectiveness of these Medicaid income only trusts, not only in protecting assets against the expanded estate recovery rules, but also in these less restrictive times of probate recovery rules. This is especially important for as of the date of this article Massachusetts is once again a probate estate recovery state, and, since assets in an irrevocable trust are not part of the probate estate, they would avoid these Medicaid estate recovery provisions.

Furthermore, these irrevocable income only trusts should be drafted as grantor trusts which provide the client the ability of having all the income generated from any such trust assets taxed on their individual income tax returns. In addition, if the property in such a trust was the client's primary residence and they were to sell it during their lives, they would be able to avail themselves of either the $250,000 capital gains tax exclusion if single, or the $500,000 exclusion if married provided, however, that they have otherwise owned and used such property as their primary residence for two of the last five years.

From a gift tax standpoint, since the donors reserve a limited power of appointment over the trust assets, it makes the gift incomplete for gift tax purposes, thereby resulting in no gift tax consequences when the assets are transferred to the trust. From a capital gains tax standpoint, it is critical that the trust be designed to ensure the family gets a step up in basis on the trust property upon the donor's death, as the assets transferred to these trusts are generally highly appreciated real estate with very low basis. This is accomplished by having the client serve as donor and trustee of the trust while reserving an income interest, thereby violating Internal Revenue Code section 2036 which will result in the trust assets being included in the donor's gross estate upon his demise. Internal Revenue Code section 2036 indicates that if an individual transfers assets to a trust and retains an income interest or the right to control the beneficial enjoyment of the trust property that such property would be included in the donor's estate. It is this inclusion in the donor's gross estate, but not the probate estate, that preserves the step up in basis for the underlying real estate. This step up in basis would eliminate any capital gains tax that would be due if the property were to be sold shortly after the decedent's death including any depreciation recapture tax that may be involved, since Mary had rented the property over the years. This must be contrasted with the outright gift of a home to the children, which results in a carryover basis thereby trapping all the capital gain that will be taxed when the children sell it.

From a control standpoint, I generally have the client serve as donor and trustee on these irrevocable income only trusts thereby giving the client as much control over their assets during their lives as possible while maintaining the protection from the costs associated with long term care. For example, this arrangement generally allows the clients who are in charge of the trust the ability to live in the house for as long as they remain trustee even though they did not retain a legal life estate in the property. This may become a very important aspect of the trusts, especially if expanded estate recovery returns in the future. Since expanded estate recovery has been recently eliminated, the client would once again be able to retain a life estate when doing their planning but should make sure that it is done by transferring the real estate to the trust and retaining a legal life estate in the deed. This technique would serve to shorten the Medicaid disqualification period associated with this transfer. Finally, these trusts generally allow the client, who is the trustee, the ability to sell and manage the trust assets during their lives, without requiring the permission of any of the children.

Contrast this with the typical life estate arrangement, in which the client transfers the house to the children and reserves a life estate. In this situation, the client will need the permission of all the children prior to selling the home. Furthermore, there is generally adverse gift and capital gains tax consequences associated with this type of an arrangement, not to mention the fact that the children would get an early inheritance following the sale. In this regard the sale results in a portion of the proceeds equal to the value of the parents' life estates, being, allotted to them. The balance of the proceeds, which represents the remainder interest, is allocated to the children. The children would also be allocated a respective portion of the parents cost basis to be used in determining the children's capital gain for income tax purposes. This assumes the children do not live with the parents. Finally, the parents have to hope the children return their portion of the proceeds, which will likely have gift tax consequences to the extent any gift exceeds $11,000 per person per year, as this is current present interest exclusion amount for gift tax purposes.

All of these adverse consequences can be avoided by utilizing these irrevocable income only trusts. If the home is in one of these irrevocable trusts in which the parents retained a life estate, the parents, without the need to obtain permission from their children, can sell their home, claim their applicable capital gains tax exclusion and remain in charge of all the proceeds to a large degree without having to worry about asking the children to return some of the proceeds. They can even use the proceeds to buy a new home or downsize as the case may be, all without the need to obtain the children's permission. These trusts are about as close as you can get to having your cake and eating it to.