# STRUCTURING OF TRUSTS IN AN ELDER LAW PRACTICE

(Medicaid and Tax Planning in Tandem)

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## §1.01 TRUSTS IN ELDER LAW - OVERVIEW

Irrevocable trusts can be an essential ingredient in the implementation of a Medicaid plan for a senior or an individual with disabilities who is seeking medical assistance under the Medicaid program while protecting his or her assets. This article sets forth the applicable Medicaid rules and then discusses several different types of trusts which can be beneficial in the context of long term care planning for seniors. The issues presented by Qualified Income Only Trusts and Pooled Trusts under OBRA 1993 and Trusts for the sole benefit of a Child with disabilities are beyond the scope of this article.

### [1] Utilization of Trusts

There are many advantages associated with the proper use of inter vivos trusts. First, the Trustee can protect the assets of a trust, invest the principal and implement a sound investment policy. Second, the creator of the Trust can observe the implementation of the plan embodied by the Trust's existence.

Third, following the death of the creator of a trust, the Trust assets would not be subject to a probate proceeding. Filing fees and legal fees associated with an estate administration proceeding may be reduced. In addition, the delays in distribution of assets which can result from a protracted estate administration can be obviated through the use of an inter vivos trust.

Fourth, the trust instrument is a private agreement and not a matter of public record. Disputes are minimized because the built-in right to contest a will[1] does not exist in the context of a trust administration. The disposition of a trust asset is thus more difficult to challenge than the same disposition in a probate context.

Finally, trusts can be formulated to achieve income and transfer tax savings and also protect the assets of the trust grantor in a Medicaid context.

### [2] Medicaid Trust Law

There are three basic types of trusts, the revocable living trust, the irrevocable living

[1] See, e.g. N.Y. SURR. CT. PROC. ACT §1404 (McKinney 2001).

trust and the testamentary trust, all of which vary in the degree of asset protection which they can provide the trust grantor in a Medicaid context. As to the revocable living trust, the assets and income of this type of trust are considered an available resource and income of the Grantor-Medicaid applicant for purposes of Medicaid eligibility and hence not an effective planning tool for protection of assets. With regard to the irrevocable living trust, this type of trust is a key planning tool for financing long term care. Not only does the Grantor receive the traditional benefits of a living trust such as asset management, continuity, preservation of control and avoidance of probate, but also a properly drafted trust will not result in the trust assets being counted as an available resource for purposes of Medicaid eligibility.[2]

Concerning the testamentary trust, COBRA and OBRA 1993 provide that the Medicaid Qualifying Trust and OBRA 1993 Trust restrictions do not apply to testamentary trusts. Hence, one can still utilize a testamentary trust providing the trustee with discretionary powers to distribute principal and/or income limited to the supplemental needs of a disabled individual such as a surviving spouse. Thus, trust assets would not be considered an available resource for purposes of the disabled individual's Medicaid eligibility, if properly drafted. One must understand that the Medicaid laws affecting Trusts will vary from State to State.

## [3] PRE OBRA 1993 TRUSTS

Medicaid Qualifying Trusts. The first stage in the analysis of the benefits of a Medicaid protection trust is a thorough understanding of the Medicaid law applicable to trusts. For Trusts established on or before August 10, 1993 (hereinafter: Pre-OBRA 1993 Trusts), the following federal Medicaid laws are applicable: Pursuant to Section 9506 of the Comprehensive Omnibus Reconciliation Act of 1985 ("COBRA"), P.L. 99-272 which amended Section 1902 of the Social Security Act, effective for medical assistance on or after June 1, 1986, if a trust is considered a "Medicaid Qualifying Trust (“MQT”)", the maximum amount that could be paid to a Medicaid applicant, given full exercise of discretion by the trustee, is treated as an available resource of the Medicaid applicant (42 U.S.C. § 1396a(k)(1).[3] This rule applies even if the trust is irrevocable, established for purposes other than Medicaid eligibility and even if the trustee never exercises the discretionary power to make such a distribution.[4]

A "Medicaid Qualifying Trust" is an inter vivos trust established by an individual (or an

[2] The limitation of the trustee’s discretion would likely result in a protection of the asset for Medicaid purposes, subject to the applicable State Law. See e.g. N.Y. EST. POWERS & TRUSTS LAW §7-1.12.

[3] See 42 U.S.C. §1396a(k)(1).

[4] Id.

individual's spouse) under which the individual may be the beneficiary of all or part of such payments from the trust and the distribution of such payments is determined by one or more trustees who are permitted to exercise any discretion with respect to the distribution to the individual.[5] Even though OBRA 1993 has since repealed the Medicaid Qualifying Trust (MQT) provisions, the courts have held that the MQT provisions continue to apply to pre-OBRA trusts.[6] A 1996 Louisiana Court[7] recently held that a trust set up by the father for his son and funded with the son's personal injury settlement is not a Medicaid Qualifying Trust, relying upon *Kegel v. State.*[8]

## §1.02 OBRA 1993 TRUSTS

### [1] What Is a Trust?

First, the Medicaid Qualifying Trust provisions have been eliminated for trusts created after August 10, 1993. The new law[9] requires the inclusion of assets that are in certain types of trusts, which had not been previously classified as Medicaid Qualifying Trusts. The new law distinguishes between Revocable and Irrevocable trusts and establishes rules regarding each. Additionally, the term "trust" includes any similar legal instrument or device, but annuities will only be treated as such in the manner the Secretary specifies.[10]

An individual is considered to have established a trust[11] *if assets of the individual* were used to form all or part of the corpus of the trust. This trust must be established *other than by Will* by the following individuals: the individual, the individual's spouse, 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, or a person, including a court or administrative body,

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5 Vincent J. Russo and Marvin Rachlin, NEW YORK ELDER LAW PRACTICE, (2001 ed.), at § 15:3.

6 *Cook v. Dept. of Social Services*, 225 Mich. App. 318, 570 N.W.2d 674 (Mich. Ct. App. 1997) see also Bernard A. Krooks, "OBRA '93- A 60 Month Look Back: the Continued Viability of Income-Only Trusts," 2 NAELA Quarterly (Fall 1998)

7 *Sanders v. Pilley*, 684 So.2d 460.(La. App.1 Cir.1996)

8 *Kegel v. State*, 113 N.M. 646, 649, 830 P.2d 563,566 (1992).

9 42 U.S.C. § 1396p(d).

10 Id.

11 42 U.S.C. §1396p(d)(2)(A)

acting at the direction or upon the request of the individual or the individual's spouse.[12]

These OBRA 1993 trust rules apply without regard to the purposes for which the trust is established.[13] Additionally, the OBRA 1993 rules are applicable irrespective of whether the trustees have or exercise any discretion under the trust, regardless of any restrictions on when or whether distributions may be made and notwithstanding any restrictions on the use of distributions from the trust.

The Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) expanded the original concept of the Medicaid qualifying trust rules which had made trust assets and/or income available only to the extent that the trustee had discretion to distribute such assets and/or the income to the grantor.

In the case of an irrevocable trust, under OBRA 1993,[14] if there are any circumstances under which payments from the trust could be made to or for the benefit of the "individual," the portion of the corpus of the trust, or the income on the corpus, from which payment to the individual could be made shall be considered available to the individual. Payments from the corpus or income of the trust shall be considered income of the individual. Furthermore, payments for any other purpose are considered a transfer of assets by the individual, subject to the 36 month "look back" period.[15] If the trust is irrevocable, the transfer is considered to have been made as of the date the trust was established or, if later, the date upon which payment to the grantor was foreclosed.

As to the revocable trust, OBRA 1993 emphatically mandates that the trust corpus is considered an available resource to the individual.[16] Payments from the trust to or for the benefit of the individual are considered income of the individual, and other payments from the trust are considered assets transferred by the individual for purposes of the transfer of assets

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12 Id.

13 See however, §24.02[4] infra,for discussion on OBRA 1993 exempt trusts.

14 42 U.S.C. § 1396p(d)(2)(A).

15 See HCFA Transmittal 64 § 3258.4E and the letter of Robert A. Streimer, Director of Disabled and Elderly Health Program Group, United State Department of Health and Human Services to Dana E. Rozansky, Esq. of Begley, Begley and Fendrick dated February 25, 1998
(A copy of this letter is on file with the author)

16 42 U.S.C. § 1396p(d)(3)(A)(i)

rules. These transfers are subject to the 60 month "look back" period.[17]

OBRA 1993 defines a trust, for Medicaid purposes, as a trust created by the individual, his or her spouse, a person or a court with authority to act on behalf of the individual or his or her spouse, or anyone acting at the direction of the individual or his or her spouse.[18] By including third persons or courts acting on behalf of or at the direction of the individual or his or her spouse, this definition removes any question as to whether a court-ordered trust could avoid the deeming provisions of OBRA 1993. Clearly such trusts are subject to the same interpretation as any other trusts.

## [2] LOOK BACK RULES FOR TRANSFERS

### [a] Medicaid Look Back Period for Trust Related Transfers

In addition to expanding the Medicaid qualifying trust provisions, under OBRA 1993 Congress established a new “look back period” for trusts.[19] A “look back period” is the period preceding the Medicaid application during which the local Medicaid agency can examine financial transactions and transfers. This new law not only increased the look back period for outright transfers from thirty (30) months to thirty-six (36) months[20], but established a sixty (60) month look back period for assets transferred into or out of an Irrevocable Trust[21].

The effect of the sixty (60) month look back period will depend entirely on the value of the assets placed into the trust. Thus, if an individual places $252,000 into a trust, and the penalty period is thirty-six (36) months (assuming a nursing home average regional private pay rate of $7,000 per month), the individual would be Medicaid eligible after thirty-six (36) months. In this instance, the sixty (60) month look back period would have no effect on the transfer into the trust because the penalty period was shorter than the look back period. The sixty (60) month look back period becomes significant only if the value of the assets placed into an irrevocable trust creates a penalty period in excess of thirty-six (36) months, or there are multiple transfers to both the trust and directly to other individuals which can create a

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17 See §24.02[2], <u>infra.</u>

18 42 U.S.C. §1396p(d)(2)(A).

19 42 U.S.C. §1396p(c)(B)(i)

20 <u>Id</u>.

21 <u>Id</u>.

penalty period in excess of thirty-six (36) months[22].

Under OBRA 1993[23], the "look back" period for identifying uncompensated transfers of assets is 36 months[24]. However, when an individual establishes a Revocable Trust a portion of which is disbursed to someone other than the grantor or for the benefit of the grantor, that portion is treated as a transfer of assets for less than fair market value. When the disbursed portion of a Revocable Trust is treated as a transfer, the look back period is extended to 60 months.[25]

On the other hand, when an individual establishes an Irrevocable Trust in which all or a portion of the trust cannot be disbursed to or on behalf of the individual, that portion is treated as a transfer of assets for less than fair market value. When a portion of an irrevocable trust which cannot be disbursed to or on behalf of the individual is treated as a transfer, the look back period is extended to 60 months.

### [b] Penalty Rules for Transfer

HCFA Transmittal 64 set forth the penalty periods for Medicaid ineligibility upon an uncompensated transfer.[26] When an individual or spouse makes a transfer of assets for less than fair market value, Medicaid's payment for services received by the individual is denied for a specified period of time[27]. This period, called the "penalty period" in HCFA Transmittal 64, is based solely upon the value of the assets transferred divided by the regional cost of nursing home care.[28] OBRA 1993 also removed the cap on transfer penalty periods which are now unlimited.[29]

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22 See §24.02[3], infra.

23 42 U.S.C. § 1396p(c).

24 *Id.*

25 42 U.S.C.§1396p(c)(B)(i), one interpretation of HCFA is that the lookback period may be 36 months for revocable trusts.

26 Department of Health & Human Services Health Care Financing Administration (HCFA) Transmittal 64 §3258.5

27 *Id.*

28 Id.

29 Id.

The transfer of assets rules are effective for payments of medical assistance in calendar quarters beginning on or after October 1, 1993 without regard to whether final regulations to carry out the amendments have been promulgated.[30]

The OBRA 1993 amendments do not apply to benefits paid before October 1, 1993. The rules also are inapplicable to assets disposed of on or before August 10, 1993 or trusts established on or before August 10, 1993.

One should check State Law as to the effective dates of the OBRA 1993 Trust rules in your local jurisdiction.[31]

One must also check State and local law as to how the penalty period is calculated. The penalty period can be calculated in two ways. The first method calculates the penalty from the first day of the month in which the transfer is made. The second method calculates the penalty from the first day of the month following the month in which the transfer is made.

### [3] Multiple Transfers

When assets of significant value are involved, the elder law attorney can achieve Medicaid eligibility for a client after 36 months, by using a combination of direct transfers to individuals and to an Irrevocable Trust. The 36 and 60-month lookback rules will be applied separately, and then the assets subject to the lookback will be combined and the transfer penalty period calculated.

For example, assume that after considering all of the tax consequences, it is recommended, for Estate and Medicaid planning, that an Irrevocable Trust be established and funded with $500,000. Assume as well that the Medicaid nursing home rate for calculating transfer penalties in the individual's district of residence is $5,000. Thus, a one month penalty will result for every $5,000 that is transferred.

To minimize the period before the individual will be Medicaid eligible, only $180,000 of the $500,000 should be placed into the Irrevocable Trust. This will create a lookback period of 60 months, but a penalty period of only 36 months ($180,000 divided by $5,000 = 36). The balance of the $500,000, that is $320,000, should be transferred by outright gifts, which will be subject to a lookback period of 36 months, and a penalty period of 64 months. By utilizing the thirty-six (36) month penalty period created by funding the Irrevocable Trust and the 36

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30 HCFA Transmittal 64, §3258.2

31 *Id.*

month lookback period created by the outright transfer of the $320,000, the individual will be Medicaid eligible 36 months following the month after the funding of the Trust.

When the application is made the month following the 36th month after the transfer of assets, the penalty period for funding the Trust will be over, so the 60-month lookback will be of no concern. Further, since 36 months have elapsed since the $320,000 was directly transferred, the transfer can no longer affect the individual's eligibility.

Thus, by careful planning, the elder law attorney can use a combination of Trusts and direct transfers and avoid the effect of the 60-month lookback rule. If warranted by tax and Medicaid planning, the Trust could be funded with an amount that would create a penalty period in excess of 36 months, but less than sixty (60) months. Be careful of multiple transfers that include transfers to individuals made months after the transfer of assets to the Irrevocable Trust. This may result in a longer penalty period due to the lookback and transfer penalty rules.

## [4] Exempt Transfers

Despite Congressional efforts to place greater controls on Trusts and expand Medicaid's ability to count Trust funds, OBRA 1993 did establish a class of Trusts that are exempt from the expanded Medicaid Qualifying Trust rules and from the 60 month look-back period. For the first time in Medicaid history, Congress authorized a class of Trusts of which neither their creation nor their funding would affect the Medicaid eligibility of the creator or the beneficiary. Three kinds of trusts are excluded from application of the OBRA 1993 trust rules: the Special Needs Trust, Qualified Income Trust and the Pooled Trust.[32]

### [a] Special Needs Trusts

The Special Needs Trust, also referred to as a "Self Settled Supplemental Needs Trust," a "Disability Trust," or a "Payback Trust,"[33] is available only to individuals who are disabled and under the age of 65 years. The Trust must be funded with the assets of the individual who

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32 For a detailed discussion of the tax issues of Special Needs Trusts, see Howard J. Atlas and Vincent J. Russo "The Tax Implications of the OBRA-93 Disability Trust," 6 Elder Law Report, (May 1995).

33 For purposes of this article, we will refer to this type of Trust as a "Special Needs Trust" and a Trust set up and funded by an individual for the supplemental needs of a third party as a "Third Party Supplemental Needs Trust."

is disabled and must be created for his or her benefit by either a parent, a grandparent, or a legal guardian of the individual or a court. The funding will not affect the Medicaid eligibility of the individual.[34]

There is a statutory requirement that the disabled beneficiary be under the age of sixty-five (65) upon the creation of the Trust. If a Special Needs Trust is created for an individual who is under the age of 65, that Trust will remain exempt if the individual lives beyond the age of 65. However, any assets added to the Trust after the individual reaches age 65 will be subject to the Medicaid transfer penalty rules.[35] Although the Special Needs Trust authorized by OBRA 1993 is exempt for Medicaid eligibility purposes, it is subject to certain statutory restrictions. In order to meet statutory requirements for exemption, the Special Needs Trust must contain a pay back provision. Upon the death of the individual, any balance left in the Trust must be paid back to the Department of Social Services in an amount not to exceed the Medicaid benefits paid on behalf of the individual. The remaining balance can then be distributed to the beneficiaries of the trust as provided for in the trust agreement.[36]

The language of the federal statute regarding the pay back provides that the "... state will receive all amounts remaining in the trust upon the death of such individual up to an amount equal to the total Medicaid assistance paid on behalf of the individual under a state plan under this title."[37] This language raises an issue whether Medicaid is entitled to recover any assistance paid on behalf of the individual prior to the creation of the Trust. Since upon the death of the disabled individual the balance of the Trust funds will not be part of that individual's probate estate, it would not be subject to a Medicaid estate claim.[38] Thus, if the individual received Medicaid assistance prior to the creation of the Trust, and if the Trust was left with considerable assets after the individual's death, the issue of whether Medicaid benefits granted prior to the creation of the Trust are recoverable is an important one.[39]

If the Special Needs Trust is funded with the proceeds of a negligence or medical malpractice suit brought on behalf of the beneficiary of the Special Needs Trust, there will be a

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34 NEW YORK ELDER LAW PRACTICE, *supra* note 5, at §15:8.

35 *Id.*

36 *Id.*

37 42 U.S.C. § 1396p(d)(4)(B)(ii).

38 NEW YORK ELDER LAW PRACTICE, supra note 5, at §15:8.

39 *Id.*

Medicaid lien against the proceeds for the repayment of Medicaid benefits paid to treat the injury or condition caused by the negligence or medical malpractice.[40]

### [b] Qualified Income Trusts

The Qualified Income Trust, the second exempt Trust authorized by OBRA 1993 has no application in the State of New York. It is a Trust funded solely with an individual's income. It is useful only in an Income Cap State. An Income Cap State is one in which the state establishes a maximum income level for Medicaid recipients. If an individual has income, even one dollar, in excess of the maximum income level or income cap, such individual is not eligible for Medicaid, even if the medical expenses are greater than the amount of income over the income cap. For example, an individual in an income cap state could be ineligible for Medicaid because of a $10 per month income excess, and have no Medicaid coverage for a $3,000 per month nursing home bill.[41]

OBRA 1993 helped alleviate this situation by authorizing a Qualified Income Trust to accept an individual's monthly income. The Trust would then authorize payment to the individual of a monthly amount that is less than the income cap of the state. The Trust would hold all of the excess income, and the individual would be Medicaid eligible. This type of Trust has no age or disability requirements. It does, however, have the same pay back requirements as the Special Needs Trust. All Trust funds remaining upon the death of the individual are to be paid back to the state up to the total amount of Medicaid benefits paid on behalf of the individual. Some States are an income spend-down rather than an income cap state. In an income spend-down State, an individual with income in excess of the Medicaid income limit is eligible if his or her medical expenses exceed the excess income. This type of Trust is not necessary in an income spend-down State and by federal statute is not available for Medicaid applicants/recipients of income spend-down States.[42]

### [c] Pooled Trusts

The third type of exempt Trust established by OBRA 1993 is the "Pooled Trust", which is available to residents of every state, including New York. In a Pooled Trust, the assets of many individuals who are disabled are held in a single Trust with a separate account for each individual. Like the Special Needs Trust, this Trust is limited to individuals who are disabled,

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40 *Id.*

41 *Id.*

42 HCFA Transmittal 64, §3259.7(C).

but unlike the Special Needs Trust, there is no requirement that the individual be under the age of 65. A disabled individual of any age can benefit from the pooled Trust.[43]

For a Pooled Trust to be exempt, OBRA 1993[44] requires that it be established and managed by a non-profit association. A separate account for each disabled individual must be maintained within the Trust. These Trusts may be funded by the disabled individual, or his or her parents, grandparents, legal guardian or by a court. Pooled Trusts must have language similar to the Special Needs Trust, so that payments from the Trust will not replace or reduce Medicaid benefits.[45]

Like the two exempt Trusts discussed above, the Pooled Trust also requires a pay back provision. Upon the death of the disabled individual, the balance in his or her account, up to the amount of Medicaid paid on his or her behalf, must be paid back to the State or its designated Department of Social Services. However, unlike the other two exempt Trusts, the pay back provision can be avoided with a Pooled Trust. If the individual elects to leave the remaining funds in the Trust after his or her death, the pay back requirement will not apply. There is no explanation in the statute as to how the remaining funds of a deceased disabled individual will be handled. Since each individual must have a separate account, it is unexplained in the law where the funds of a deceased individual would pass.[46]

The Pooled Trust may be the preferred by a family that desires to have any remaining funds benefit the other beneficiaries of the non-profit organization rather than having the Trust assets paid to the government in satisfaction of the cost of services provided under the Medicaid program.[47]

## §1.04. TAX CONSEQUENCES OF IRREVOCABLE LIVING TRUSTS

Since an Irrevocable living Trust will be the instrument of choice in order to protect assets for an individual who may enter a nursing home in the future, it is essential that the Trust be structured in the most favorable manner for tax purposes. It is important to keep in mind that most of the individuals who set up this type of Trust will not have a taxable estate.

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43 42 U.S.C. §1396p(d)(B)(4)(C)(i)

44 *Id.*

45 NEW YORK ELDER LAW PRACTICE, supra note 5, at §15:8

46 *Id.*

47 *Id.*

## [1] Income Taxation

An irrevocable living trust is a trust established during the Grantor's lifetime in respect of which the Grantor has no power to alter, revoke or amend. Such a trust can be either a separate taxable entity or a conduit through which income is passed to the beneficiaries.

Income generated by the trust assets is taxable to the trust, the grantor or other beneficiaries of the trust, depending upon how the trust has been structured.[48] The theory is that either the trust or the beneficiary, but not both, should be taxed on the income. The "flow through" of income (and its character) from a trust to a beneficiary is sometimes referred to as the "Conduit Theory" of Sub-chapter J. Income is taxable to the trust if it is accumulated by the trust.[49] On the other hand, income is generally taxable to the beneficiaries to the extent that the trust actually distributes the income to them or makes it available to them.[50] The Grantor may be taxed on trust income in accordance with any of the Grantor trust rules.[51] The rationale is that the Grantor is considered the owner of all or a portion of the Trust and thus must pay tax on the Trust's income.[52]

In a Medicaid asset protection context, the Irrevocable Trust is typically drafted so that the trust is treated as a "Grantor Trust." This is helpful when the grantor is in a lower income tax bracket than other beneficiaries named in the trust.[53]

Distributable Net Income or DNI, a term which exists only in the context of trust and estate income taxation, allocates income tax liability between a trust and a trust beneficiary.[54] DNI is used to compute a trust's income tax deduction for amounts distributed to the beneficiaries. DNI is also used to quantify the amount that a beneficiary needs to report as income from the trust. The trust can be drafted so that part of the income is taxable to the trust and part to the beneficiaries.

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48 I.R.C. §671.

49 Seiden and Christin, 852 T.M., Income Taxation of Trusts and Estates, at A-68.

50 *Id.*, at A-66.

51 I.R.C. §§671-677.

52 I.R.C.§673(a).

53 I.R.C. §§671,672, 674, 675.

54 I.R.C. §643(a).

## [2] Gift Taxation--Funding of the Trust

Upon funding of the trust, there may be a transfer of assets for gift tax purposes, depending upon the terms of the trust.[55] The trust beneficiaries, rather than the trust or trustee, are the donees.

Once the Grantor has parted with dominion and control over the property so that the Grantor cannot change its disposition, the gift is deemed completed[56]. On the other hand, a gift is incomplete in every instance in which the donor reserves the power to re-vest the beneficial title to the property to him/herself.[57] A gift is also incomplete if and to the extent that a reserved power to name new beneficiaries or to change the interests of the beneficiaries as between themselves, unless the power is a fiduciary power limited by a fixed or ascertainable standard.[58]

If the Grantor retains a power over the disposition of the trust assets, such as a testamentary power of appointment over the remainder upon death, then no portion of the transfer is considered a completed gift.[59] Therefore, gift taxes can be avoided upon funding of such a trust or at the time a revocable trust becomes irrevocable.

If the Grantor is physically or mentally incapable of exercising the limited power of appointment, will "possession" of the limited power cause the funding of the trust to be an incomplete gift? Case law and an IRS Revenue Ruling have held that the mere possession at death of the power, rather than the exercise of, or inability to exercise the power is the proper criterion to cause the funding of the trust to be an incomplete gift.[60]

If the transfers funding the trust were classified as completed gifts subject to gift tax, then the distributions from the trust are not gifts. On the other hand, if the transfers funding the trust were classified as incomplete gifts and hence not subject to gift tax, then the

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55 I.R.C. §2501.

56 Treas. Reg. §25.2511-2(b)

57 Treas. Reg. §25.2511-2(c).

58 *Id.*

59 *Id.*

60 See Rev. Rul. 55-518, 1955, 12 C.B. 384; *Boeving v. U.S.*, 493 F. Supp 665 (D.Mo. 1980), rev'd 650 F. 2d 493 (8th Cir. 1981), *Alperstein v. Commissioner*, 613 F. 2d 1213 (2d Cir. 1979), cert. denied, 446 U.S. 981 100 S. Ct. 1852, 64 L.Ed. 2d 272 (1980).

distributions from the trust to individuals other than the grantor are "gifts".[61]

Should the Grantor retain a partial interest such as a life estate, then only the remainder interest will be considered a completed gift. However, pursuant to I.R.C. § 2702, a transfer to certain family members with a retained life estate would be *valued* for gift tax purposes as if the entire fee interest in the property was transferred and not just the remainder interest.[62]

The gift to the Trust may also qualify for the $10,000 annual exclusion, as long as the present interest requirement is satisfied.[63] Methods of satisfying this requirement are: (i) providing for "Withdrawal Powers," sometimes referred to as "Crummey Powers"[64] in the trust; or (ii) mandating the distribution of income, at least annually.[65] The gift to the Trust may also qualify for the marital deduction if the QTIP requirements of I.R.C. § 2056(b)(7) are met.[66]

It is important to keep in mind that if one of the above techniques is implemented, such a provision may adversely affect the grantor's Medicaid eligibility.

### [3] Estate Taxation

If the gift is incomplete or if the grantor has retained powers over the transferred property under I.R.C. §§ 2035 - 2038, such property will be included in the Grantor's estate at death.[67] For example, if the Grantor is the recipient of some part or all of the trust income and/or principal, the trust principal will be fully included in the Grantor's gross estate for estate tax purposes because the Grantor has reserved an income interest from the trust created by the Grantor.[68]

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61 Treas. Reg. §25.2511-2(f).

62 I.R.C. §2702.

63 I.R.C. §2503.

64 *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

65 Treas. Reg. §25.2503-3(b).

66 I.R.C. §2056(b)(7).

67 I.R.C. §§2035-2038.

68 I.R.C.§§2036-2038.

If the trust property is included in the grantor's estate, then the beneficiaries will receive the property with a step up in basis to the fair market value of the property on the decedent's date of death (See I.R.C. § 1014(a)(1) or the alternative valuation date under I.R.C. § 2032 (I.R.C. § 1014((a)(2).[69]

## §1.05. MEDICAID GUIDELINES

### [1] Exchange of Property

If one of the objectives is to have the income of Trust treated as the Grantor's income, then the Trust can be tainted with a retained power to exchange property of equivalent value under I.R.C. § 675.

Depending upon the local jurisdiction, the Trust may be treated as available for purposes of the Grantor's Medicaid eligibility. There are more conservative ways of tainting the Trust without running the risk that the local Medicaid Agency will challenge the availability of trust assets.

### [2] Lifetime Powers of Appointment

Another technique to taint the Trust for purposes of rendering the funding of the Trust as an incompleted gift is for the grantor to retain a limited power of appointment.

The trust can be drafted with a limited power of appointment provision so that the funding of the trust will be treated as an incomplete gift for gift tax purposes.[70] If the grantor has an estate of under $675,000 (for 2000-2001), then there are no federal gift tax consequences and the need for the limited power of appointment would be unnecessary (unless there is a state gift tax incurred for such a gift, or highly appreciated assets have been placed in the trust). If the trust is funded with an amount greater than $675,000 (for 2000-2001), then the limited power of appointment would eliminate any gift tax consequences.

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69 Query whether the beneficiaries of an irrevocable Trust will receive a "stepped up basis" for capital gain purposes in 2010. Under a literal reading of the new federal tax law, there would not be a stepped up basis if the transferor passes away after 2009 since the acquisition of property from an irrevocable trust does not fall within the definition of "property acquired from the decedent." See Economic Growth and Tax Relief Reconciliation Act of 2001, §541, amending I.R.C. §1014.

70 See Treas. Reg. §25.2511-2.

A conservative drafting approach would include a testamentary limited power of appointment in the trust instrument (not a lifetime power of appointment) so that the funding of the trust would be treated as an incomplete gift for gift tax purposes. Upon the death of the Grantor, the trust principal would be included in the Grantor's estate[71] and the beneficiaries of the Trust would receive a stepped up basis and avoid capital gains consequences.[72]

One must look at the local jurisdiction to determine whether the use of either a lifetime or testamentary power of appointment is advisable for purposed of protecting assets for Medicaid.

### [3] Power to Remove the Trustee

If a Grantor retains the right to remove a trustee and replaces the trustee with anyone, including himself, this provision would cause the assets of the Trust to be included in the Grantor's estate for tax purposes.[73] A variant of this technique, which could protect both the principal and income of the trust for Medicaid purposes, would be for the Grantor to reserve the right to remove a Trustee and replace the Trustee with anyone, except himself. Arguably, the ability of the Grantor to appoint a person who is related or subordinate to the Grantor[74] would cause the assets of the Trust to be included in the Grantor's estate. If the assets of the Trust were includable in the Grantor's estate, then the beneficiaries of the Trust would receive a step-up in basis.[75] Here again, state law must be checked as to whether this technique will also protect the assets from a Medicaid standpoint.

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71 I.R.C. §2041.

72 I.R.C. §1014. After the repeal of the estate tax in 2010, a carryover basis regimen will be instituted. The retention of a power of appointment by a Grantor is specifically excluded from the definition of property acquired from a decedent and is thus ineligible for the stepped up basis. Economic Growth and Tax Relief Reconciliation Act of 2001, §541, amending I.R.C. §1014.

73 See Treas. Reg. §20.2036-1(b)(3), 20.2038-1(a). The Trust instrument must also give the Trustee broad discretion to distribute income and/or principal to the beneficiaries. Under such circumstances, the Trustee's power to distribute is imputed to the Grantor.

74 See I.R.C. §672(c). Rev. Rul. 95-58 set forth two requirements for a retained right to remove a Trustee to escape estate taxation. First, the Trust must not allow the grantor to appoint himself as Trustee. Second, the Trust must prohibit the Grantor from appointing related or subordinate parties as successor Trustees. If a Trustee removal provision only prohibits the Grantor from becoming the Trustee, then arguably the second requirement of Rev. Rul. 95-58 would have been contravened, causing the Trust assets to be includable in the Grantor's estate. See Rev. Rul. 95-58, 1995-2 C.B.

75 See I.R.C. §1014.

## [4] Mandate Income to the Grantor

An Asset Protection Trust which mandates that income shall be paid to the Grantor would protect the principal of such trust for Medicaid purposes. The income, of course, would be considered as part of the Grantor's total available income for Medicaid purposes. A trust with a mandatory income provision would be includable in the Grantor's estate.[76] Assets passing to the beneficiaries of such a trust would receive a step-up in basis.[77]

The following language is illustrative of the mandatory income trust provision:

*During the lifetime of the Grantor, the Trustee shall pay or apply the net income of the Trust Estate to or for the benefit of the Grantor.*

This provision will clearly achieve the tax objectives of income taxation to the Grantor and inclusion in the Grantor's estate for estate tax purposes (hence obtaining a stepped up basis) as the expense of conceding the income to Medicaid in an income spend-down state. If the Trust provision is adopted in an Income Cap State[78], this technique may cause eligibility problems.

## [5] Planning with the Residence

### [a] Planning Options

For many seniors, the primary residence is their most important and valuable asset. Often, seniors are concerned about losing their residence in the event of a catastrophic illness. There are three primary planning techniques in the context of Medicaid planning: (i) the transfer of a residence, outright; (ii) the transfer of a residence with a retained life estate and (iii) the transfer of a residence to an Irrevocable Trust.

As to the third technique, an individual's residence can be placed into and be owned by an Irrevocable Trust by executing a deed in which the trustees of the Trust are the grantees. Like any other transfer of property into an Irrevocable Trust, the transfer will cause a Medicaid transfer penalty for nursing home care equal to the value of the residence divided by

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76 See I.R.C. §2036(a)

77 See I.R.C. §1014

78 See *infra* §1.02[4](b).

the monthly average regional cost of nursing home care.[79]

### [b] Advantages of Trust to Outright Transfer

The effect of an outright transfer of the residence on Medicaid eligibility would be the same as a transfer to an Irrevocable Trust. However, in some circumstances, the transfer of the residence into a Trust can be preferable to an outright transfer.[80] The outright transfer would be a gift subject to gift taxes, whereas the transfer to the Trust could be structured to have no gift tax consequences.[81] By avoiding gift tax consequences, the residence would remain part of the grantor's estate, which has a planning advantage. The residence would be subject to a “step up in basis” upon the death of the grantor. Thus, the cost basis for tax purposes of the beneficiaries of the Trust will be the market value of the property at the time of the grantor's death.[82] The transfer of the senior’s residence into the irrevocable trust is an excellent way of avoiding capital gains on a highly appreciated residence. The same “step up in basis” can be obtained with a direct transfer if the grantor retains a life estate. Query, whether a “step up in basis” will be available if the estate tax law is repealed in 2010.[83]

### [c] Advantages of a Life Estate to a Trust

A direct transfer subject to a retained life estate has two advantages over a transfer into an Irrevocable Trust. First, the life estate is given a value, which reducing the value of the transfer for Medicaid eligibility purposes.[84] No such reduction is provided for under Medicaid law when the transfer is to an Irrevocable Trust.[85] Second, if the grantor has a senior citizen's real estate reduction and/or veteran's real estate tax exemption, such exemption/reduction can generally be retained by use of the life estate.[86] A transfer to a Trust may cause a loss of a

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79 See HCFA Transmittal 64 §3258.5.

80 See §24.02[3], *supra*.

81 *Id*.

82 I.R.C. §1014.

83 See note 69, *supra*.

84 A table of the values of life estates and remainder interests can be found in HCFA Transmittal 64, §3258.9, citing Treas. Reg. §20.2031-7.

85 See §1.02[2][b], *supra*.

86 See, e.g. McKinney’s New York Real Property Tax Law §§425(3), 458-1(5), 458(7), 467(10).

senior citizen's and/or a veteran's real estate tax exemption/reduction, under certain circumstances. For example, in New York, the loss of the real estate tax exemption can be avoided if the grantor is a trustee, or if the transfer to the Trust is itself subject to the Grantor's life estate.[87] One should consult state and local law as to the specific trust language required to preserve the grantor's real estate tax exemptions.

### [d] Disadvantages of a Retained Life Estate to a Trust

The use of an Irrevocable Trust rather than a direct transfer subject to a life estate can have a distinct advantage that may compensate for the disadvantages mentioned above. If a residence is transferred directly to a third party subject to a life estate, and that residence is sold at any time during the transferor's lifetime, there are three disadvantages to the transferor and/or his or her family.

First, the step up in basis will be lost, and any gain on the sale (the value between the transferor's cost basis and the sales price) during the transferor's lifetime will be subject to income taxation.[88] Second, the signature of both the life tenant and the remainder persons would be required to sell such property during the lifetime of the transferor.[89] The dual signature requirement could cause a problem if any of the individuals lack capacity, and there is no Durable Power of Attorney authorizing such a power.[90] In contrast, the trustees of a Trust can sell property without the consent of anyone else.[91] Third, the life tenant is entitled to a portion of the sale proceeds based upon the value of his or her life estate. Thus, the local Medicaid agency will consider the value of the transferor's life estate as an available resource for Medicaid eligibility purposes. Because the value of a life estate is often very substantial, there can be a significant adverse effect on Medicaid eligibility. On the other hand, if the residence were in a Trust, its sale would produce no entitlement for the grantor, and would have no effect on his or her Medicaid eligibility.

The question of placing an individual's residence into an Irrevocable Trust will require an analysis of the family circumstances, including whether Medicaid eligibility is contemplated, whether there is a community spouse in good health and whether there are any

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[87] See, *Id*.

[88] NEW YORK ELDER LAW PRACTICE, *supra* note 5, at §15.18.

[89] *Id*.

[90] *Id*.

[91] Unless the transfer to trust was itself subject to a life estate.

plans to sell the residence during the individual's lifetime. The value of the individual's estate is also important in order to decide whether a transfer to a Trust, which will cause the property to be included in the individual's estate, is the most advantageous plan.

### [e] Title Insurance

When the residence is transferred into the Irrevocable Trust, will the grantor still be entitled to continued title insurance? This may depend upon the type of deed utilized to transfer the residence into the trust and the coverage provisions of the title insurance. For example in New York, if a bargain and sale deed is utilized, then the title insurance coverage terminates, but if a warranty deed is utilized, then the title insurance coverage continues. One should check with the title insurance carrier as to coverage provisions and consult the applicable state law as to the type of deed which will be required for ongoing title insurance coverage.

## [6] DRAFTING ISSUES

Seniors want to control their own assets to the fullest extent possible. Depending upon how the Irrevocable Living Trust is drafted, the senior may be able to maintain control in certain ways without adversely affecting the senior's Medicaid eligibility.

### [a] Trustee Selections

Often, the grantor is interested in maintaining as much control over the trust principal as possible. The question then arises as to whether the grantor or his or her spouse may be a trustee of his or her own trust. An examination of the provisions of OBRA 1993 and HCFA Transmittal 64 reveals no reason why the grantor or his or her spouse cannot be a trustee of the trust, as long as the trustee cannot benefit in any way from the principal of the trust. Notwithstanding this analysis, it would be prudent <u>not</u> to have the grantor or his or her spouse serve as trustee of the trust to avoid any arguments that the state may make in regard to the availability of assets for purposes of the grantor's Medicaid eligibility.

### [b] Governing Law

The attorney drafting the trust will typically have the situs of the trust governed by the laws of the state in which the individual resides. One might consider adding a change of situs provision which would give flexibility to the trustee to change the situs of the trust to another jurisdiction. This could be extremely helpful if the grantor decides to change his or her residency (domicile) to another state. More importantly, if the laws of one state are more restrictive than another state in the context of Medicaid, then the Trust could provide that the less restrictive state's law apply to the trust. By analogy, this technique has often been utilized in the context of the estate tax planning.

### [c] Distributions for the Benefit of the Grantor

It is important that the trust be drafted so that the grantor cannot receive or benefit from any distributions of principal from the trust. HCFA Transmittal 64, § 3259.6 D. provides:[92]

> "Payments made for the benefit of the individual are payments of any sort, including an amount from the corpus or income produced by the corpus, paid to another person or entity such that the individual derives some benefit from the payment. For example, such payments could include purchase of clothing or other items, such as a radio or television, for the individual. Also, such payments could include payment for services the individual may require, or care, whether medical or personal, that the individual may need. Payments to maintain a home are also payments for the benefit of the individual." [93]

Based upon this section of the HCFA Transmittal 64, it is imperative that the trustees and the grantor's family be advised to ensure that the grantor receives no benefit from the distribution of principal to family members.

### [d] Termination of Trust upon Death of the Medicaid Spouse

In a situation when a well spouse has set up an Irrevocable Trust to protect assets because the ill spouse will require long term care in the future, the question arises as to whether the Trust must continue after the death of the ill spouse for the benefit of the well spouse? One might consider establishing a trust which would terminate upon the death of the Medicaid applicant with the assets held in that trust being distributed outright to the individual's spouse.

Once the transfer penalty period has expired in respect of the funding of the trust, the grantor-Medicaid applicant can obtain Medicaid. Since the purpose of the trust was to remove the assets as countable for purposes of the community spouse resource allowance, upon the demise of the Medicaid applicant spouse, the need to protect the assets would not exist. Hence, the trust could terminate with the assets being distributed to the community spouse

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[92] HCFA Transmittal 64, §3259.6D

[93] *Id.*

leaving him or her with total control over the assets from that point forward. This approach may work particularly well when the ill spouse has long term care insurance to cover the cost of his or her care during the Medicaid transfer penalty period caused by the funding of the Trust.[94]

In addition, if the community spouse is elderly and also looking to protect assets with regard to his or her own long term care, then it would be preferable for the trust to continue in a protective way for the benefit of the community spouse (such as an income only trust for the community spouse) or to have the trust terminate with the assets distributed to the grantor's children.

### [e] Discretionary Distributions to Third Parties

There are two situations when a discretionary provision to distribute principal to third parties can be useful. First, if the trust allows income to be distributed to the grantor and grantor applies for Medicaid, then the income will be paid to the nursing home. Note that if the income is greater than the Medicaid reimbursement rate, then Medicaid will be denied or if the income exceeds the income cap, if applicable, Medicaid will be denied. Instead, in accordance with the discretionary distribution provision, the trustee could distribute all or part of the principal to a third party, thus, allowing the grantor to access Medicaid. Second, the trustee could make discretionary distributions to family members in need, without adversely affecting the Grantor's Medicaid eligibility.

## §1.06 THIRD-PARTY SUPPLEMENTAL NEEDS TRUSTS

This type of trust is set up by the grantor with the grantor's own assets for the benefit of a third party. There are two typical situations in which such a trust is established: A child sets up a trust for an elderly or disabled parent or a parent sets up a trust for the special needs of a disabled child. These trusts are known as Supplemental Needs Trusts. The trust instrument usually provides for discretionary trustee powers to utilize income or principal for the benefit of a primary beneficiary, without replacing any government benefits. These powers must be drafted in accordance with applicable State law.

### [1] Nature of Trust and Medicaid Law

A Supplemental Needs Trust can be established by an individual with the individual's own assets for the benefit of a third party to supplement, but not duplicate or reduce Medicaid benefits. This type of Trust is to be distinguished from a Self Settled Trust, such as a Special

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[94] The State may attempt to make a claim against the surviving spouse as to the Medicaid benefits paid to the deceased spouse. If such a claim were successful, then the distribution of the trust's assets to the spouse would adversely affect that spouse.

Needs Trust. Because the Supplemental Needs Trust is not one of the OBRA 1993 exempt trusts, there is no required pay back to the State for Medicaid provided to the disabled beneficiary.[95] This type of trust is designed to protect the special needs of a child or grandchild with disabilities. As with exempt and other trusts for the benefit of individual with disabilities, care must be taken to avoid substituting the grantor's assets for the assets of a government program benefitting the individual with disabilities. The trust can be established as an inter vivos trust or as a testamentary trust. For example, in New York, the language of a Third Party Supplemental Needs Trust can be based upon the safe harbor language of New York's Estates Powers and Trusts Law (hereinafter "EPTL") §7–1.12.[96] In New York the use of Supplemental Needs Trusts prior to the enactment of EPTL 7-1.12 was based on case law.[97]

### [2] Drafting Issues

#### [a] Distributions for the Benefit of the Grantor or Third Party Persons

Because this is a third party trust, there can be great flexibility regarding distribution to any one other than the disabled individual. Whereas an outright distribution to the disabled beneficiary would affect eligibility for any means tested program such as Medicaid, the trust can provide for an outright distribution to the grantor, without affecting the disabled beneficiary.[98]

Similarly the trust can provide for discretionary distribution to third parties. Because this is a third party trust, it is not controlled by the limitations of OBRA 1993.[99] Thus, the discretionary provisions regarding distribution to third parties other than the individual with disabilities should have no effect on the eligibility of the individual with disabilities.

#### [b] Termination of Trust upon the death of the Beneficiary

A grantor may use this type of trust to make distributions to third parties upon the death of the disabled beneficiary. By keeping trust assets out of the estate of the individual

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95 NEW YORK ELDER LAW PRACTICE, *supra* note 5, at §15:19, §15:21.

96 N.Y. EST. POWERS & TRUSTS LAW §7-1.12.

97 *Matter of Escher*, 94 Misc. 2d 952, 407 N.Y.S.2d 106 (Surr. 1978), aff'd mem. 75 A.D.2d 531 (1st Dept. 1980), aff'd 52 N.Y. 1006, 438 N.Y.S.2d 293 (1981).

98 New York Elder Law Practice, *supra* note 5 at §15:21.

99 *Id.*, Cf. §§15:8 and 15:19.

with disabilities, any possibility of an estate recovery is avoided. Once the need to protect the disabled child is ended, it is possible and often desired to provide for outright distribution to third parties, such as other children.

### [c] Lifetime Powers of Appointment

The trust may be drafted with a limited power of appointment provision so that the funding of a inter vivos third party supplemental needs trust will be treated as an incomplete gift for gift tax purposes. If the grantor has an estate of under $675,000 (for 2000-2001) , then there are no federal gift tax consequences and the need for the limited power of appointment would be unnecessary (unless highly appreciated assets have been placed in the trust).[100] If the trust is funded with an amount greater than $675,000 (for 2000-2001), then the limited power of appointment would eliminate any gift tax consequences.

### [d] Trust Management and Administration

The management and administration of a Third Party Supplemental Needs Trust is one of the most flexible of the supplemental or special needs trusts. Because it is not subject to the rules of OBRA 1993 and is not an exempt trust the drafter is much freer to satisfy the desires of the grantor. Broad discretion can be given to trustees regarding income and principal distribution to anyone other than the disabled individual. Although there is no statutory expansion of trustee discretion, caution must still be exercised regarding any benefits actually provided to the disabled individual. One must check the law of the local jurisdiction as to how much flexibility will be permitted.

## [3] Tax Consequences of Third Party Supplemental Needs Trusts

### [a] Income Taxation

The trust will be taxed as a separate entity. Since the typical Supplemental Needs Trust is a discretionary trust for income tax purposes, it will be treated as a complex trust. Hence, as a general statement, income will be taxed to the recipient of the income. If the income is not distributed in a given year, then the trust will be responsible for the tax at the trust income tax rates which are higher than the individual income tax rates.[101]

### [b] Gift Taxation

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100 See §1.05[2], *supra*.

101 An individual pays the 39.1% rate of tax on income exceeding $297,350, whereas a trust would pay 39.1% tax on income exceeding only $8,900. See Internal Revenue Code Income Taxes §1-860L, CCH, at vii-viii (June, 2001 ed.).

If the Supplemental Needs Trust is a testamentary trust, then there are no gift tax consequences. If the trust is an inter vivos trust, then there may or may not be gift tax consequences, depending upon the provisions of the trust, such as whether the trust is revocable or irrevocable, or whether the trust contains a limited power of appointment.[102]

### [c] Estate Taxation

If the trust is established under a Will, the assets funding the trust will be included in the estate of the deceased grantor. The trust may or may not be subject to estate taxation in the estate of the beneficiary of the trust, depending upon the provisions of the trust, such as whether the trust gave the beneficiary a general power of appointment.[103] Typically, a testamentary supplemental needs trust would be drafted so that the trust assets would not be included in the estate of the beneficiary so as to avoid any government claims on the death of the beneficiary.

## §1.07 SPECIAL NEEDS TRUST (SELF SETTLED)

### [1] Nature of Trust and Medicaid Law

The Special Needs Trust, also referred to as a "Self Settled Supplemental Needs Trust," a "Disability Trust," or a "Payback Trust,"[104] is available only to individuals who are disabled and under the age of 65 years. The Trust must be funded with the assets of the individual who is disabled and must be created for his or her benefit by either a parent, a grandparent, or a legal guardian of the individual or a court. The funding will not affect the Medicaid eligibility of the individual.

OBRA 1993 authorizes the funding of a Trust for the benefit of an individual who is disabled under the age of 65 using such individual's own assets (referred to as a "Special Needs Trust," "Self Settled Supplemental Needs Trust," "Disability Trust" or a "Payback Trust").[105] In order to qualify as an exempt Trust, the document must provide for a payback to Medicaid following the death of the individual who was disabled, from any balance remaining

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102 See §1.05[2], *supra*.

103 I.R.C. §2041.

104 For purposes of this article, we will refer to this type of Trust as a "Special Needs Trust" and a Trust set up and funded by an individual for the supplemental needs of a third party as a "Third Party Supplemental Needs Trust."

105 NEW YORK ELDER LAW PRACTICE, *supra* note 5, at §15:20.

in the Trust.[106] The elder law attorney drafting a Trust pursuant to the statutory exemption of OBRA 1993 must use great care to assure that the payments from the Trust to the individual do not affect such individual's Medicaid eligibility.[107] Payments from the Trust to the individual receive no statutory protection, and must therefore, be designed so as not to duplicate or replace any Medicaid funding.[108] Any duplication or replacement of Medicaid funding would result in the Trust having to pay for expenses that would otherwise be covered by Medicaid.[109] Thus, if a Special Needs Trust authorized the trustee to pay the beneficiary's medical expenses with no qualifying language, Trust funds would have to be exhausted before Medicaid would pay any medical expenses.[110]

## [2] Drafting Issues

### [a] Distributions for the Benefit of the Individual with Disabilities

Special Needs Trusts are intended to supplement rather than duplicate or replace Medicaid benefits. To accomplish this and achieve the benefits of a Special Needs Trust, the trustee's authority must be carefully defined and limited. The Trust instrument must contain a provision prohibiting the trustee from paying for any expense that would otherwise be paid for by Medicaid or any other means tested entitlement program.[111] In New York, statutory guidance for the language of a Special Needs Trust can be found in state law, such as New York's EPTL 7-1.12.[112] It is recommended that the applicable state statute be cited in the Trust, if existing, and that state-specific statutory language be used where appropriate. Most States do not have specific statutory language.

Care must also be taken to prevent direct payments to the individual, because direct unrestricted payments are income to the individual which would affect his or her Medicaid eligibility.[113] Provision can be made for the trustee to spend Trust funds on specific items that would not be covered by Medicaid. For example, the trustee could be authorized to purchase

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106 *Id.*

107 *Id.*

108 *Id.*

109 *Id.*

110 *Id.*

111 *Id.*

112 NEW YORK EST. POWERS & TRUSTS LAW §7-1.12 (McKinney 2001).

113 NEW YORK ELDER LAW PRACTICE, supra note 5 at §15:20.

a television set for the individual. Since a television set is not a medical item provided by Medicaid, such authorization or purchase would not affect the individual's Medicaid eligibility. The type and number of items and services that can be authorized by a Special Needs Trust are limited only by the need to avoid any replacement or duplication of items or services available from Medicaid and of the needs of the beneficiary.[114]

Funding a Special Needs Trust with the proceeds of a medical malpractice or negligence action, against which a Medicaid lien had been placed, has always been a problem depending on the amount of the lien as compared to the amount of the settlement. Given the State's legal ability to recover, the attorney for the disabled individual should negotiate a reduction or waiver of the lien based on the circumstances of the case. It will be more difficult to negotiate if a large sum of money will be left for the trust after payment of the lien. The attorney should make every effort to avoid paying a Medicaid lien which will reduce the amount available to be placed in the Trust.

In drafting the Trust, it is also important to take into account whether the beneficiary is seeking Supplemental Security Income (SSI).

### [b] Termination of Trust upon the Death of the Beneficiary

Since the Special Needs Trust is an OBRA 93 exempt trust, it must terminate upon the death of the beneficiary. Because this is a "pay back" trust it contains provisions requiring that the trust assets remaining upon the death of the beneficiary be first used to reimburse Medicaid for all medical assistance paid on behalf of the beneficiary.[115] The trustee must therefore obtain a statement from Medicaid setting forth the amount of medical assistance paid. If the remaining trust assets exceed the amount due and owing to Medicaid, then the excess will be distributed in accordance with the testamentary provisions of the trust. If the amount owed to Medicaid exceeds the remaining trust assets, then the remaining trust principal will be paid to Medicaid and nothing will be distributed to third parties.

In spite of the statutory language seemingly requiring the repayment of "all" medical assistance paid on behalf of the beneficiary, it is prudent to check Medicaid's accounting. If Medicaid seeks repayment of expenses paid prior to the establishment of the exempt trust, such payment should be resisted. The trust should only be liable for any medical assistance granted as a result of the trust. Any medical assistance granted prior to the trust was based on the individual eligibility of the individual with disabilities, and any recovery of those benefits should be governed by Medicaid's standard statutory right of recovery, such as an estate

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114 *Id.*

115 HCFA Transmittal 64, §3259.7A.

claim.[116]

### [c] Discretionary Distributions to Third Parties

Although the exempt pay back trust generally provides benefits only for the disabled individual, there are circumstances where distributions to third parties can be drafted into the trust document and approved. One such circumstance that could justify a third party payment is when a caretaker relative may have to give up or forgo employment to be able to remain at home and provide necessary home care to the disabled individual. In such a case, a monthly stipend can be requested from the Trustee to reimburse the caretaker for expenses and/or lost income.[117]

Another example is a trust provision authorizing the purchase and maintenance of a specially equipped motor vehicle necessary for the transportation of the disabled individual. Authorization can also be sought for the payment for structural changes to the home in which the beneficiary lives, such as, a wheelchair ramp; widened doorways; a stair lift and bathroom fixture replacement. Discretionary distribution to third parties must be related to the care, maintenance and well being of the beneficiary. No distribution totally unrelated to the benefit of the disabled individual will be approved.[118]

## [3] Tax Consequences of Special Needs Trusts

### [a] Income Taxation

Settlement Payments to the Special Needs Trust. Once payments from medical malpractice settlements are funded into the Special Needs Trust, counsel must consider who will be taxed on the interest and dividends that the Trust assets generate. From a tax planning standpoint, under most circumstances, it is preferable for the income to be reported by the individual with disabilities, instead of the Trust itself, since under current tax law the Trust tax brackets apply at lower levels of taxable income than for individuals.[119] Even though the 2001 federal income tax rates range from 10% to 39.1% for both individuals and Trusts, an individual will reach a 39.1% tax bracket at $297,350 of taxable income (in 2001), while a

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116 As to Medicaid's statutory estate claim right of recovery, see generally NEW YORK ELDER LAW PRACTICE, *supra* note 5, at §10:3.

117 See e.g. NEW YORK ELDER LAW PRACTICE §15.28 for form.

118 *Id.*

119 I.R.C. § 1(a)-(e).

Trust will reach the same bracket at a taxable income of $8,900 (in 2001).[120]

In order for the Trust income to be considered taxable to the individual with disabilities at the lower tax rate, the Trust must be considered a "Grantor Trust" for income tax purposes.[121] A Grantor Trust can be best described as a Trust under which the individual has retained some level of interest or control in the Trust which causes the grantor to be considered the owner of the Trust property. To ensure that the individual with disabilities is taxed on the Trust income, it is critical that the Trust be drafted in accordance with the Grantor Trust rules.[122] In order to obtain Grantor Trust treatment, the individual with disabilities need not be named as grantor of the Trust document. The grantor of a Trust can be the senior who furnishes the Trust funds, not necessarily the individual named as grantor in the Trust agreement.[123]

The following two provisions may be utilized within the Trust document to secure Grantor Trust status:

[i] The Trust may include a provision that would allow the individual with disabilities an unrestricted power to remove, substitute or add trustees and to designate any person including himself or herself as the replacement trustee. This type of power is deemed to be a "right to control the beneficial enjoyment of the Trust property."[124] With this power, income will be taxed to the grantor.[125]

[ii] The Trust may provide the individual with disabilities with certain administrative powers, such as the power to reacquire Trust corpus in a nonfiduciary capacity by substituting other property of equal value.[126] With this administrative power, the Trust income will be taxed to the

120 *Id*.

121 I.R.C. §§ 671–677.

122 *Id*.

123 See *Blackman v. United States*, 48 F.Supp. 362, 98 Ct.Cl. 413 (Ct.Cl.1943); see also Priv. Ltr. Rul. 9004007.

124 I.R.C. § 674(a).

125 Treas. Reg. §1.674(d)-2.

126 I.R.C. § 675(4).

grantor.[127]

Furthermore, the IRS has held that a minor will be treated as the owner of a Grantor trust created by a court for the benefit of such minor and funded with the proceeds of a personal injury suit filed on the minor's behalf.[128]

### [b] Gift Taxation

With regard to gift tax liability, one must determine whether upon the payment of settlement proceeds into the Special Needs Trust a completed gift has been made by an individual with disabilities. Generally, the essential elements of a valid *inter vivos* gift are:

[i] A donor competent to make the gift;

[ii] A clear and unmistakable intention on his or her part to make it.;

[iii] A donee capable of accepting the gift;

[iv] A conveyance, assignment, or transfer sufficient to vest the legal title in the donee, without power of revocation at the will of the donor; and

[v] A relinquishment of dominion and control of the subject matter by delivery to the donee.[129]

The transfer of property constitutes a completed gift to the extent that the donor has parted with dominion and control of the property so as to leave him or her without a power to change the disposition, whether for his or her own benefit, or for the benefit of another.[130]

The individual with disabilities has recourse through court review to ensure the Trust is funded with the settlement proceeds and is used for his or her benefit. Given the above basic principles of law and definition of a completed gift, one may conclude that there is sufficient dominion and control by the individual with disabilities over Trust assets to render the funding of the Trust an incomplete gift.

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127 I.R.C. § 675.

128 I.R.C. §§ 671-677; see also Rev. Rul. 83-25, 1983-1 C.B. 116; Priv. Ltr. Rulings 9502019,9502020,9502024, 9502029 and 9502031 (1995).

129 Edson v. Lucas, 40 F.2d 398, 404 (8th Cir.1930).

130 Treas. Reg. § 25.2511-2(b).

From a tax planning perspective, this is the position the individual with disabilities will typically want to take in order to avoid gift tax liability at the time the Trust is funded. To further substantiate this viewpoint, one could take the position that the funding of the Trust is part of a negotiated settlement and arguably not a gift by the individual. Another position one could take is that the individual with disabilities did not intend to make a gift of the settlement proceeds since the Trust is created for his or her primary benefit and no one other than such individual can benefit from the Trust during his or her lifetime, thereby, rendering the funding an incomplete gift.

To avoid this issue entirely, the attorney should draft the Trust document properly to insure that the funding of the Trust is an incomplete gift. If the individual who is disabled retains a power over the disposition of Trust assets, such as a testamentary power of appointment over the remainder upon death, then no portion of the funding should be considered a completed gift.[131]

Even if the individual with disabilities does not have the requisite legal capacity to execute a Last Will and Testament and thus, cannot exercise the limited power of appointment, the funding of the Trust can still be considered an incomplete gift. Current case law and an IRS Revenue Ruling have taken the position that the mere possession at death of the limited power, rather than the actual exercise of, or inability to exercise the power, is the determinative criterion.[132]

### [c] Estate Taxation

#### [i] Estate Inclusion-Trust Assets

Generally, if the individual who is disabled has retained an interest in the Trust or sufficient powers over the Trust property, then the Trust will be included in the disabled individual's estate.[133] All assets in which an individual has an interest at the time of death, are part of his or her gross estate for purposes of estate taxation.[134] Conversely, if the individual with disabilities has retained no interest in, or control over the Trust property, the funding of the Trust is a completed gift subject to gift tax and not part of the estate for estate tax

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131 Treas. Reg. § 25.2511–2(b), see also Priv. Ltr. Rul. 9437034 (1994).

132 See *Boeving v. United States*, 650 F.2d 493,(8th Cir.1981); *Alperstein v. Commissioner of Internal Revenue,* 613 F.2d 1213,(2d Cir.1979), cert. denied 446 U.S. 918, 100 S.Ct. 1852, 64 L.Ed.2d 272 (1980); Rev. Rul. 55-518, 1955-2 C.B. 384.

133 I.R.C. §§ 2033–2041.

134 I.R.C. § 2033.

purposes.[135] As a result, the drafting of the Trust agreement can have a significant impact on the gift and estate tax consequences of the Trust.

Drafting the Trust to allow the individual who is disabled the power to determine who will receive the remainder of the Trust property at his or her death, could be considered sufficient control to avoid a gift tax liability upon funding the Trust. The IRS has officially agreed with this position in a private letter ruling.[136] This private letter ruling involved a personal injury settlement paid into an Irrevocable Trust for the benefit of a disabled child. The IRS held that the Trust assets were includable in the disabled child's estate since the decedent child retained a special testamentary power of appointment over the Trust (the power to alter the disposition of the Trust corpus at his death). Thus, the transfer of the funds into the Trust constituted an incomplete gift[137] and the Trust corpus was includable in the child's estate.[138]

In Technical Advice Memorandum 9506004,[139] the Internal Revenue Service took the position that the settlement proceeds of a tort action brought on behalf of a minor and placed in two irrevocable Trusts by his guardians were includable in the minor's gross estate for estate tax purposes.[140] The proceeds were includable not only under I.R.C. § 2038 due to a testamentary power of appointment, but also under I.R.C. § 2036 because the Trust corpus could be consumed for the minor's needs. Under the terms of the Trust agreement, the trustees had broad discretion to distribute income or principal for the minor. In a recent U.S. Court of Claims case, the Court held that the Trust assets of a Supplemental Needs Trust were included in the decedent's estate for estate tax purposes.[141]

### [ii] Estate Inclusion-Future Periodic Payments

If a personal injury lawsuit settlement is structured so that annuity payments continue to be paid to a disabled individual's parents upon the individual's demise, the present value of the annuity payments to be received by the parents (the remainder beneficiaries) is

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135 See Treas. Reg. 25.2511-2(b).

136 Priv. Ltr. Rul. 9437034 (1994).

137 I.R.C. § 2511.

138 I.R.C. § 2038.

139 Tech. Adv. Mem. 9506004 (Nov. 1, 1994).

140 Tech. Adv. Mem. 9506004 (Nov. 1, 1994).

141 Arrington v. United States, 34 Fed.Cl. 144, 76 A.F.T.R.2d 95–6762, 95–2 U.S.T.C. ¶ 60,212 (Fed.Cl.1995), aff’d, 108 F.3d 1393 (Fed.Cir.1997).

included in the decedent's estate.[142]

Since the remaining annuity payments are includable in the disabled individual's estate, the continued payment stream must be valued. There are three potential approaches to valuing the amount to be included in the decedent's estate:

[i] The cost of a commercial annuity;[143]
[ii] The value based on discounting future payments at 120% of the average federal midterm rate[144] on the date of death;[145] or
[iii] The price a willing buyer would pay a willing seller for the right to receive future payments.[146]

Although not involving periodic payments of personal injury settlements, two Tax Court cases valued continuing annuity payments at the cost of a commercial annuity and not pursuant to the willing buyer/willing seller rule.[147] It is likely that the IRS will utilize the commercial annuity valuation or at a minimum, the valuation specified under I.R.C. § 7520 and resist applying the willing buyer/willing seller approach.

If the settlement is structured as a payment stream which continues paying the deceased disabled individual's family over a number of years, there may be insufficient Trust assets to pay the estate tax which is due within nine months after the decedent's death. Under this scenario, the estate may request that the estate tax be paid in installments over time.[148] If the IRS grants this request, there will be no penalty for not paying the estate tax within nine months from the decedent's date of death, but interest will have to be paid on each installment.

## §1.08 MEDICAID PLANNING OPTIONS FOR THE INDIVIDUAL

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142 I.R.C. § 2039.

143 Treas. Reg. § 20.2031–7.

144 The federal midterm rate, also known as the applicable federal rate (A.F.R.), is promulgated on a monthly basis. See Rev. Rul. 2001-58 for December 2001 Rates. This rate is used to assist in valuations for gift and estate tax purposes. I.R.C.§§ 7520 and 1274(d)(1).

145 I.R.C. § 7520.

146 Treas. Reg. § 20.2031–1(b).

147 Estate of Bell v. United States, 80–2 U.S.T.C. ¶ 13,356, 1980 WL 1700 (E.D.Wash.1980); *Estate of Raimondi v. Commissioner of Internal Revenue*, 29 T.C.M. (CCH) 70, T.C.Memo. 1970–025, T.C.M.(P–H) 70,025,1970 WL 1529. (Tax Court 1970).

148 I.R.C. § 6166.

## WITH DISABILITIES UNDER AGE 65

Assuming the individual who is disabled has mental capacity, a decision must be made as to whether it is more advantageous to implement Medicaid planning by asset transfers or by placing his or her assets into an exempt individual Special Needs or Pooled Trust.

Consideration will have to be given to the possible transfer penalty period, if an exempt Trust is not established, and whether the individual is better off with transfers either outright or to an Irrevocable Trust as compared to funding a Pooled or Special Needs Trust. If the individual does not require immediate Medicaid benefits, then he or she may be willing to forgo Medicaid during the transfer penalty period. In such a plan, the transferred assets will not be subject to recovery by Medicaid.

The tax consequences of the transfer to an irrevocable trust must also be considered for it is preferable to structure carefully a transfer so that income is taxable to the Grantor and the proceeds are includable in the estate of the Grantor. The utilization of the power to remove a trustee will insure the *inclusion* of the Trust assets in the Grantor's estate without potential state Medicaid objections to limited powers of appointment. The inclusion of Trust assets in the Grantor's estate will result in the beneficiaries receiving a corresponding benefit in reduced capital gains exposure if the asset is sold after the death of the Grantor.

The age of the individual must also be considered. If the individual with disabilities is young, counsel must consider that Medicaid benefits paid when the individual was under the age of 55 are not recoverable and that a Medicaid estate claim can only go back ten (10) years. In some cases, divesting assets which can create a Medicaid transfer penalty period may be more advantageous than funding an exempt Trust coupled with a pay back requirement or retention by a non-profit organization.

## §1.09 WHEN TO USE TAX STRUCTURED TRUSTS IN MEDICAID PLANNING

Seniors are seeking to maintain maximum control over their assets, the use of the Irrevocable Trust can ensure protection of assets when Medicaid is needed. Individuals who are looking to help family members who are disabled can take advantage of Third Party Supplemental Needs Trusts to supplement the needs of that family member without affecting the individual's governmental benefits that are available. For individuals under age 65 and disabled, the use of a Special Needs Trust can ensure Medicaid eligibility with the Trust assets being used to enhance the quality of life of the individual. The opportunity is there for the advisors to then take the next step and incorporate tax planning to minimize income, estate and gift tax consequences.

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