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# Navigating Tax Issues in Medicaid Planning: Key Rules and Strategies to Avoid Costly Mistakes

Outright Gifts vs. Gifts to a Trust, Income Taxes, Capital Gains, Real Estate Tax Exemptions, Retirement Savings and Distributions

THURSDAY, DECEMBER 8, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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# Income Tax Concerns Related to Trust Planning

# Individual Income Tax Rates 2021

| Taxable Income | Marginal Tax Rate |
|---|---|
| Not over $9,950 | 10% |
| Over $9,950 but not over $40,250 | 12% |
| Over $40,250 but not over $86,375 | 22% |
| Over $86,375 but not over $164,925 | 24% |
| Over $164,925 but not over $209,425 | 32% |
| Over $209,425 but not over $523,600 | 35% |
| Over $523,600 | 37% |

# Estate and Trust Income Tax Rates 2021

| Taxable Income | Marginal Tax Rate |
|---|---|
| Not over $2,650 | 10% |
| Over $2,650 but not over $9,550 | 24% |
| Over $9,550 but not over $13,050 | 35% |
| Over $13,050 | 37% |
| | |

# Traditional Grantor Trust Planning

One successfully achieves grantor trust status while removing the assets from his or her estate for estate tax purposes if:

The trust includes a power exercisable in a nonfiduciary capacity to reacquire the assets by substituting assets of equivalent value, without the approval or consent of any person in a fiduciary capacity;

IRC § 674 (4)(c) and Treas. Reg. § 1.675-1(b)(4)(iii).

The trust includes a power to add the class of beneficiaries (other than to provide for after-born or after-adopted children), including, without limitation, a charitable beneficiary; or

IRC § 674(a).

The trust includes a power to enable the grantor to borrow money or assets from the trust without adequate interest or security.

IRC § 675.

# Powers to Control Beneficial Enjoyment

General Rule. Code §674(a) provides that a grantor shall be treated as the owner of any portion of a trust in respect of which beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Code § 674: Power to Control Beneficial Enjoyment

# Powers to Affect Beneficial Enjoyment

The powers described below can be exercised by any person without causing a trust to be a grantor trust status.

- Power to apply income in support of a dependent.
- Postponed power to affect beneficial enjoyment.
- Power exercised only by Will. (Code 674)(b)(3).
- Power to distribute principal. (Code §674(b)(5).
- Power to withhold income temporarily.
- Power to withhold income during disability of beneficiary. (Code §674(b)(7)).
- Power to allocate between income and corpus (code §674(b)(8).

Code § 674: Power to Control Beneficial Enjoyment

# Power Exercisable only by Will

Code§674(b)(3) provides that a power exercisable solely by Will generally does not cause a trust to be owned by its grantor.

Example:

- A trust instrument provides that trust income is to be accumulated during the life of the grantor's spouse, who may appoint the trust income by Will, without the consent of an adverse party.

# Power to Distribute Principal

Grantor trust status will not be triggered as a result of a power to distribute corpus to trust beneficiaries that is limited by a reasonably definite standard or a power to distribute corpus to current income beneficiaries.

Code § 674: Power to Control Beneficial Enjoyment

# Power to Distribute Corpus is Limited

Reasonably Definite Standard

For instance a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency, would be limited by a reasonably definite standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not limited by a reasonably definite standard…"

Code § 674: Power to Control Beneficial Enjoyment

# Administrative Powers

Overview/Purpose:

Code §675 treats a grantor as owner of any portion of a trust if administrative control of the trust is exercisable primarily for the benefit of the grantor rather than for the beneficiaries of the trust.

# General Powers of Administration

If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interest of the beneficiaries.

Power to Control Trust Investments:

A grantor will be treated as owner of any portion of a trust over which any person has a power, to control the investment of the trust fund either by directing the investments or reinvestments.

Power to Reacquire Trust Assets:

A power to reacquire trust corpus by substituting property of equivalent value will result in grantor trust status.

Code § 675: Administrative Powers

# Viable Choices for Causing Grantor Trust

1. A power exercisable in a nonfiduciary capacity to reacquire the assets by substituting assets of equivalent value, without the approval or consent of any person in a fiduciary capacity (IRC § 674 (4)(c) and Treas. Reg. § 1.675-1(b)(4)(iii))
2. A power to add a class of beneficiaries such as one or more charities (IRC § 674(a))

# Power Exercisable only by Will

Code§674(b)(3) provides that a power exercisable solely by Will generally does not cause a trust to be owned by its grantor. If, however, the power of appointment governs income and principal, the trust will be a grantor trust.

Example:

- A trust instrument provides that trust income is to be accumulated during the life of the grantor's spouse, who may appoint the trust income by Will, without the consent of an adverse party.

# Income Tax Concerns Related to Crisis Medicaid Planning

# Problem Assets Related to Medicaid

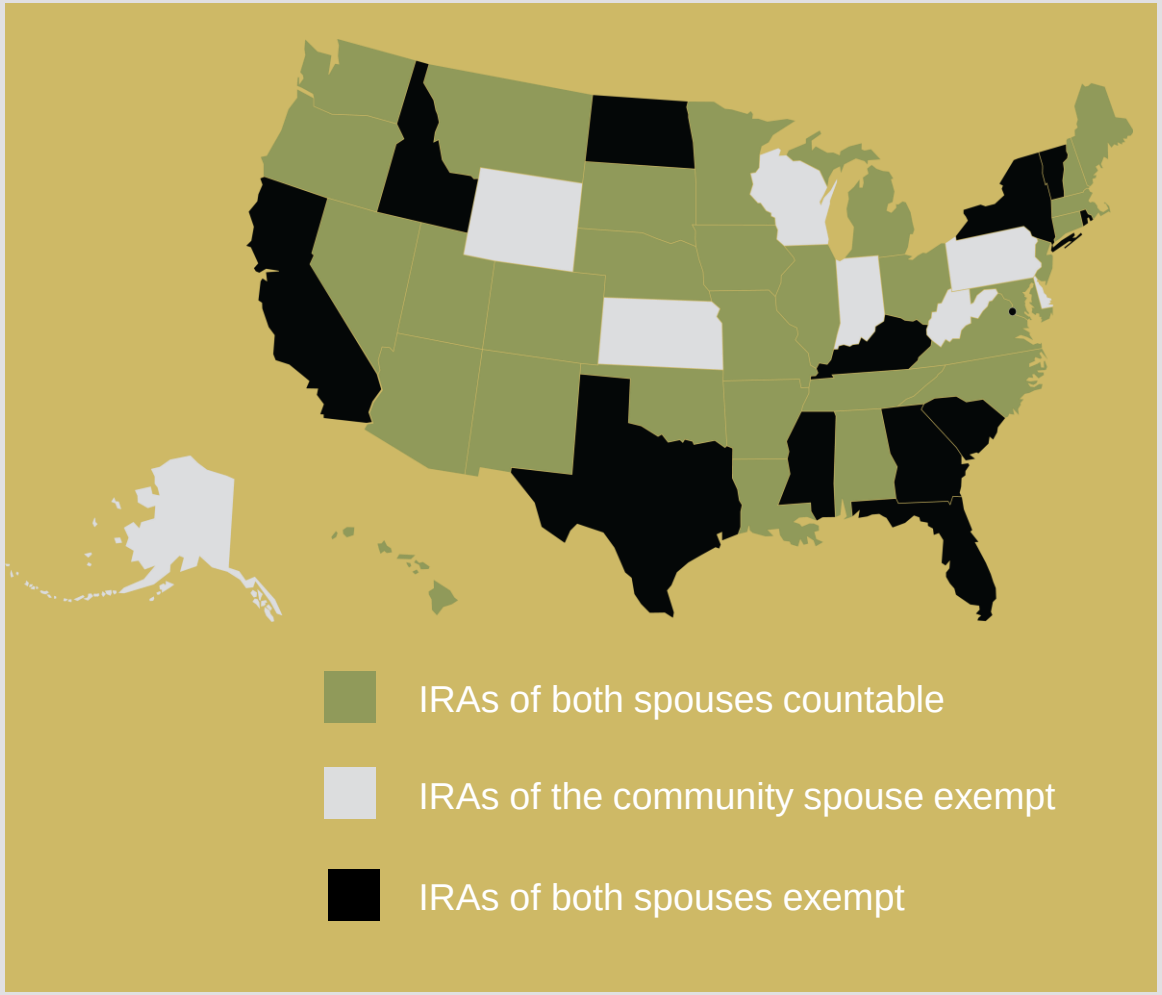
- Clients often liquidate accounts to reduce their countable assets below their state-specific asset limitation - Crisis Medicaid Planning.
- However, liquidating certain assets can trigger tax consequences for the client.
- These problem assets typically include:

IRAs

Tax-Deferred Annuities

# Medicaid's Treatment of IRAs

- Exempt or countable status for IRAs varies by state.
  - In some states, IRAs of both spouses are considered exempt.
  - In other states, only IRAs belonging to the community spouse are exempt.
  - In most states, IRAs belonging to either spouse are considered countable assets and must be spent down.



# Treatment of Tax-Deferred Annuities

- Because a tax-deferred annuity always has a cash surrender value, it is a countable asset to the extent of that value.
- There might be an exception if the annuity is also an IRA and IRAs are exempt in your state.

# Consequences of Liquidating These Assets

- The account will incur a significant tax hit.
  - For traditional IRAs, the entire account is taxable.
  - For tax-deferred annuities, the appreciation is taxable.
- As taxable income increases, so do the tax brackets – 10% to 37%.
- If a married couple's income exceeds $44,000, 85% of their Social Security benefits become taxable.
- If a married couple's income exceeds $182,000, their Medicare Part B and Part D premiums increase.

# Solution:
# Medicaid Compliant Annuity

- A Medicaid Compliant Annuity (MCA) is a single premium immediate annuity with added restrictions to meet Medicaid's requirements.
- An MCA converts excess countable assets into an income stream with zero cash value.
- ***Most importantly, it can be funded with an IRA or a Tax-Deferred Annuity, eliminating excessive taxation.***

# Requirements of an MCA

- **Irrevocable**
  - The payment amount, term, and parties cannot be altered.
- **Non-assignable**
  - The contract cannot be assigned or sold to another party.
- **Actuarially sound**
  - The term of the annuity must be fixed and equal to or shorter than the owner's Medicaid life expectancy.
- **Equal payments**
  - The annuity must provide equal monthly payments with no deferral or balloon payments.
- **State as beneficiary**
  - In most cases, the state must be named primary beneficiary to the extent of benefits paid on behalf of the institutionalized individual.

# Funding an MCA with an IRA

- The transfer of IRA funds to an MCA is not a taxable event.
- Instead, the funds are taxed as payments from the IRA-MCA are made within each calendar year.
- This allows your client to spread any tax liability over the term of the annuity.
- There are two options for transferring the funds:
  - ***60-Day Rollover***
  - ***Trustee-to-Trustee Transfer***

# 60-Day Rollover

- The proposed IRA-MCA owner contacts the current IRA custodian directly and requests a liquidation of the account without withholding taxes.
- The client will receive a check and has 60 days to reinvest the funds into an IRA-MCA.
- **Disadvantage:** The client receives a 1099-R the following year.
- Note: The IRS limits 60-Day Rollovers to one every 365 days.

# Trustee-to-Trustee Transfer

- The proposed IRA-MCA owner completes some additional paperwork with their annuity application.
- Then, the insurance company issuing the IRA-MCA obtains the funds directly from the current IRA custodian.
- **Advantage:** The client does not receive a 1099-R.
- This option may take up to six weeks to complete.

# Funding an MCA with a Tax-Deferred Annuity

- Clients can also use an existing deferred annuity to fund an MCA.
- This option is helpful if the client has experienced significant appreciation on the policy that would otherwise be taxable upon liquidation.
- Instead, the client can spread the tax liability over multiple years, similar to the IRA option.
- This can be accomplished through a Section 1035 Tax-Free Exchange.

# Section 1035 Tax-Free Exchange

- Section 1035 of the IRS Code allows a policy owner to exchange their policy for a "like" contract (annuity for an annuity)
- Similar to a Trustee-to-Trustee Transfer for an IRA, the client completes additional paperwork with the annuity application.
- The insurance company issuing the MCA obtains the funds directly from the old insurance company.
- **Note:** If the TDA is subject to a surrender charge, the 1035 tax-free exchange does not eliminate the penalty.

# Estate Tax and Gifting Considerations

# Testamentary GPOA vs. LPOA

GPOA- General Power of Appointment.

LPOA- Limited Power of Appointment

So long as a grantor's power to appoint trust property does not include a power to appoint income, the power would not seem to trigger grantor trust status under Code §674(b)(3). However, it is possible that a grantor's power to appoint trust property to his or her estate, his or her creditors or the creditors of his or her estate could be viewed as a Code §673 reversionary interest that would make the trust a grantor trust.

Code § 674: Power to Control Beneficial Enjoyment

# Irrevocable Trusts
# Limited Power of Appointment

I have the limited testamentary power to appoint the remaining principal and accrued or accumulated income of the trust to or for the benefit of any one or more of my descendants or any charities of my choosing. I may not exercise this power of appointment for the benefit of either of myself, my creditors, my estate, or the creditors of either of my estate.

# Anti-Clawback Regulations

# Tax Cuts and Jobs Act

- The Internal Revenue Service (IRS) finalized regulations on the anti-clawback rules.
  - The anti-clawback rules provide that a decedent will not be treated as having made taxable transfers in excess of the decedent's applicable exclusion amount at the time of the decedent's death if:
    - the decedent uses the increased estate, gift, and GST tax exclusion amounts while the Tax Cuts and Jobs Act is in effect and
    - dies after the amounts are potentially reduced.
- By transferring assets now, your clients can protect up to $12,060,000 (for an individual) or $24,120,000 (for a married couple) in assets from estate, gift, and GST tax.

# Anti-Clawback Rules

- What to do if there is difference between the basic exclusion amount that was applicable on the date of a donor's gift and the basic exclusion amount that is applicable on the date of death.
  - If the total amount allowable as a credit in computing the gift tax on the decedent's gifts is greater than the credit that is allowable in computing the estate tax on the decedent's taxable estate, then the portion of the credit used in computing the estate tax is the sum of the basic exclusion amount that used as a credit in computing the gift tax
  - Treas. Reg. § 20.2010-1(c)(1)

# Anti-Clawback Rules

Individual A (never married) made cumulative taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $11.7 million in basic exclusion amount.

The basic exclusion amount on A's date of death is $6.8 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017- 15.

Because the total of the amounts allowable as a credit in computing the gift tax payable on A's gifts (based on the $9 million of basic exclusion amount used to determine those credits) exceeds the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, the credit for purposes of computing A's estate tax is based on a basic exclusion amount of $9 million.

Treas. Reg. § 20.2010-1(c)(2)(i) Example 1

# Anti-Clawback Rules

- Individual B's predeceased spouse, C, died before 2026, at a time when the basic exclusion amount was $11.7 million. C had made no taxable gifts and had no taxable estate. C's executor elected to allow B to take into account C's $11.7 million DSUE amount.

- B made no taxable gifts and did not remarry. The basic exclusion amount on B's date of death is $6.8 million.

- The credit to be applied for purposes of computing B's estate tax is based on B's $18.5 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.7 million DSUE amount.

  - Treas. Reg. § 20.2010-1(c)(2)(iii) Example 3
  - DSUE applied before BEA is applied to gifts

# Gifting Intent Language

- I specifically intend that:
  - any transfers made to this trust be treated as a completed gift for federal estate and gift tax purposes and
  - the assets of the trust estate be excluded for federal estate tax purposes from my gross estate.

# Gift Taxes, Powers, and Estate Inclusion

- Treas. Reg. § 25.2511-2(b) Definition of Completed Gift
  - "As to any property . . . of which the donor has so parted with dominion and control as to leave in him no power to change its disposition . . . the gift is complete."

# Gift Taxes, Powers, and Estate Inclusion

- Gift Taxes
  - Definition of "completed" gift
    - 25.2511-2(b) Example (part 1)

Income to donor or accumulated in discretion of trustee

\+ Retained testamentary LPOA

= Entire transfer is incomplete gift

# Gift Taxes, Powers, and Estate Inclusion

- Gift Taxes
  - Definition of "completed" gift
    - 25.2511-2(b) Example (part 2)

| | |
|---|---|
| | Income to donor or accumulated in discretion of trustee |
| + | No retained testamentary LPOA |
| = | Entire transfer is completed gift |

# Protecting the Family Home

Homes are typically a family's largest asset, especially in New York and on Long Island.

When creating an estate plan, it is important to look at the home as it relates to long term care planning. There are many things to consider.

# Valuing the Family Home

Home Appraisal:

- More costly
- Necessary when listing for sale

Broker's Price Offer:

- Simple letter
- Based on comps
- Accepted for Medicaid purposes

# Medicaid & Transferring Real Property

- The equity limitation is currently $955,000 (2022)
- Value of homes, condos & co-ops in NYC, Westchester and Long Island can exceed $955,000
- Equity limitation does not apply if there is a spouse or a minor, blind or disabled child living in the home

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# Direct Gift to Children

- Parent has no control over the house given away, could be evicted by children.
- Increased Taxes- possible loss of STAR exemption and property tax deduction, capital gains taxes on sale after death
- House will be subject to the children's creditors, divorces, etc.
- If a child predeceases, the house may go to the child's spouse, not the grandchildren.

# Life Estate

## Outright Transfer of Home Subject to a Life Estate

Benefits:

- Starts the Medicaid penalty period (reduced by the value of the life estate) for nursing home Medicaid eligibility.
- The value of the life estate is not considered an asset for Medicaid eligibility
- Protects the home after the applicable lookback period
- Step-up in basis at the time of death – no capital gains for heirs (Included in the taxable estate)
- Keeps STAR and other tax benefits of home ownership

# Life Estate

## Outright Transfer of Home Subject to a Life Estate

Drawbacks:

- Not flexible to changes in circumstances
- If sold during lifetime, possible significant capital gains tax owed by children as there is no full $250,000 exclusion. It will only apply to the value of the life estate
- The life tenant will be entitled to the value of their life estate, which could increase their resources above the allowable limit for Medicaid.
- Value of life estate returns to you, and may require a spenddown
- Difficult to change beneficiaries

# Gifts to a Medicaid Trust

## Irrevocable Trust

- Used to transfer assets for Medicaid purposes.
- Must be Irrevocable.
- The Creator cannot be a Trustee.
- Can be funded with any type of asset including real estate, cash, stocks, bonds, annuities, life insurance policies.

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# Medicaid & Transferring Real Property

- Retain the equivalent of a Life Estate.
- Retain STAR exemptions, VA exemptions, etc.
- Creator/parent keeps all rights and obligations of the property.
- Creator/parent retains the right to live in the residence.
- House can be sold and a new residence purchased.
- Trustee and children have no rights in the residence during the parent's life.

# Asset Protection/ Medicaid Trust

## Payment Options During Life

- Creator can retain right to income from the trust.
- Creator must not have any access to principal.
- Creator can provide that children or other beneficiaries have access to principal during their lifetime.

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# Asset Protection/ Medicaid Trust

- There is a 5-year look back period which the creator/parent must get past.
- May need the children to access the principal.
- Make sure trust is “flexible”.

# Medicaid Trusts: Payment Options Upon Death

- Trust Agreement must say who will receive property at the Creator's death.
- Creator can retain the right to change those beneficiaries by naming other beneficiaries in their Will.
- Funds remaining in Trust can be paid outright to selected beneficiaries or held in further trust (such as for minors).

# Asset Protection/ Medicaid Trust

Once the 5-year look back has passed, the assets in the trust are protected for Medicaid purposes.

- By planning ahead, you can protect all the assets held in the trust.
- Assets will pass free and clear to family members/beneficiaries.
- Assets will not have to be spent down on the cost of care.

# Tax Ramifications of Transferring Real Property

## Tax Consequences

- Income Taxes
- Estate Taxes
- Real Estate Tax Exemptions

## Income Tax

- Income earned by trust property is income earned by the trust
- Who is responsible for payment of income tax will vary depending on certain things:
  - If the trust receives the income, the trust is responsible for the taxes
  - The income beneficiaries will be responsible if they receive income
  - In the case of a Grantor Trust, the Grantor will be responsible and income will be reported on their individual tax return.

## Income Tax

- General Rule for Trust Income Taxes
  - Income retained by the trust is taxed to the trust
  - Income distributed to beneficiaries are taxed to the beneficiaries

- Exceptions to General Rule
  - Grantor Trusts

    Where Grantor retains an interest in the trust, the trust income will be taxed to the Grantor.

- Trusts are taxed like individuals, but rates are much higher

- Trusts may deduct certain expenses

- Personal exemptions apply

- No Standard deduction

## Allowable Trust Deductions

- Generally, the same as those allowed for an individual

- Examples of allowable deductions:
  - Administrative expenses (e.g. trustee fees, bank fees, etc.)
  - State, local and real estate taxes
  - Estate expenses (check the governing instrument!)
  - Miscellaneous itemized deductions (2% floor of AGI)


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