

Drafting Income-Only Trusts for Medicaid Eligibility and Tax Planning

Navigating Look-Back, Grantor Trust, Basis, and Gift Tax Rules

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Income-Only Trusts for Medicaid Eligibility

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Introduction to Medicaid

- Needs-based, joint federal-state program of medical assistance for individuals who are aged, blind, or disabled or who are members of families with dependent children
- Aged means 65 years of age or older
- Disabled – Social Security definition – Inability to do any substantial gainful activity – 20 C.F.R. 416.905



Introduction to Medicaid

- Medicaid is called “the payor of last resort”
- Medicaid rules differ from state to state
- Interacting with the Medicaid system is challenging and requires attention to detail, accurate information, patience and tenacity



Medicaid Criteria

- To qualify for Medicaid in the nursing home, a Resident must meet the following criteria:
 - Have been in an institution for 30 days or longer (hospital or skilled care facility)
 - Be in a nursing home (not assisted living)
 - Be in a Medicaid bed
 - Need skilled or intermediate nursing care
 - Meet Medicaid's financial criteria



Medicaid Criteria: Resources

- In Medicaid language, an asset is called a Resource.
- Resources are those assets that an individual or a couple own and can apply, either directly or by sale or conversion, to meet basic needs of food, clothing and shelter.



Medicaid Criteria: Resources

- A single person (never married, widowed, divorced, or married when both are in the Nursing Home) is resource-eligible when his or her countable resources are less than \$2,000
- A Community Spouse (CS) may keep half (50%) of countable resources up to a maximum of \$128,640 (2020 figure).
- CS may keep all countable resources if the total is less than \$25,728 (2020 figure)



Medicaid Criteria: Resources

- You cannot give away assets (resources) today and apply for Medicaid tomorrow
- Medicaid penalizes all such gifts made within the 5 years before the Medicaid application



Medicaid Criteria: Income

- Technically, if the institutionalized person's gross income is over \$2,349/month, he is not eligible for Medicaid. (2020 figure)
- Practically, income above \$2,349 is placed in a Qualified Income Trust (QIT) and he is then eligible. Bottom line – if income is less than the cost of the nursing home, he is income eligible.
- The income of the spouse of an institutionalized person is not limited.



Trusts & Medicaid, In General

- Not all Trusts are countable resources
- Federal statute controls treatment of trusts established with assets of the individual
 - By a spouse through a will,
 - By a court, and
 - Certain trusts established for disabled individuals

See 42 USC 1396p(d)



Trusts & Medicaid, In General

- All other trusts are evaluated under the general definition of “resource”
 - See also, Social Security Administration Program Operations Manual System (POMS) SI 01120.200



Irrevocable Trusts & Medicaid

- For Medicaid eligibility purposes, transfers into properly drafted irrevocable trusts are considered gifts and subject to the five-year look-back rule
- After five years, the assets are not counted for Medicaid eligibility purposes and are considered “protected.”
- BUT – to start the lookback, the irrevocable trust needs very precise language, which most irrevocable trusts do not contain
- Medicaid actively tries to pierce these trusts



Pros of Using Irrevocable Trusts

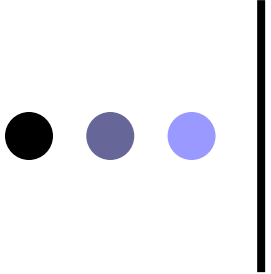
With proper drafting, you can:

- avoid the capital gains issues of outright gifting upon the grantor's death
- preserve the grantor's 121 exemption in the primary residence
- minimize the risk of the beneficiaries' creditors gaining access to the assets
- arrange for the most advantageous treatment of income



Cons of Using Irrevocable Trusts

- Hard for clients to understand
- Inflexible
- Difficult to explain to Medicaid
- Must get 5 years after transfer of assets to the trust for them to be fully protected
- If doing a gift and return, some states may not recognize returns to grantor from trust beneficiaries



When to Use Irrevocable Trusts in Medicaid Planning

- Married couples with different degrees of health and income
- Married couples who will not need long term care for 5 years
- Single individuals who will not need long term care for 5 years
- NOTE: Irrevocable Trusts are generally not advisable for crisis planning



Income Only Trusts in Medicaid Planning

Judith D .Grimaldi, Esq.

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Use of Trusts in Medicaid Planning

- In transferring assets trusts are the recommended strategy to protect assets.
- Types of Trusts:
 - Revocable- not used in Medicaid planning except by refusing spouse to avoid estate recovery and probate
 - Irrevocable – Used for asset protection
 - Special Needs
 - Discretionary
 - Sole benefit

This CLE will focus on the income only asset protection trust. (Income issues)

Trusts vs. Direct Transfers

- Trust advantages
 - Death
 - Disability
 - Debts
 - Divorce
 - Dishonesty
 - Tax benefits
 - Real estate tax discounts
 - Grantor income tax status
 - Capital gains advantages
- Direct Transfers
 - Simple, less cost
 - Greater liability issues
 - Less control
 - Less creditor protections
 - Inability to fix who will inherit
 - Limited flexibility if there is a change in plans

Drafting Trusts - Types

- Medicaid Irrevocable Income Only Grantor Trust
 - Third party must be appointed Trustee not Grantor
 - Income may be payable to grantor or Grantor's spouse or issue
 - No principal distributions to Grantor
 - Can remain includible in Grantor's estate through retained interests, for example: LPOA, etc. Benefit- secures capital gains protections and “stepped up” basis

Grantor Trust Rules for Income Tax Benefits

- Grantor trust status allows income to be taxed at the Grantor's usually lower tax rate

Not over \$2,600

10 percent of taxable income

Over \$2,600 but not over \$9,450

\$260 plus 24 percent of the excess over \$2,600

- Income tax liability remains with the Grantor

Over \$9,450 but not over \$12,950

\$1,904 plus 35 percent of the excess over \$9,450

- Trust tax rate - income of \$12,150. (37 %)

Over \$12,950

\$3,129 plus 37 percent of the excess over \$12,950

- Medicaid cautions.

Grantor status criteria

- Power to:
 - Substitute property of equivalent value (IRC 675(4). Medicaid caution
 - Designate Charitable Beneficiaries
 - Add beneficiaries (IRC 674(b)(5))
 - Use Trust Income to pay for Life Insurance (IRC 677(a)(3))
 - Borrow w/o Security (IRC 675(2). Medicaid caution
 - Receive income or any trust assets including a life use only. May not be discretionary or need approval of adverse party. IRC 677 (a) (1)
- Use individual rather than grantor to exercise these powers to avoid Medicaid implication

Trust Tax Issue- LPOA

- Limited Power of Appointment – drafting requirements and Tax issues
- What is a LPOA (Testamentary and Life time)
 - IRC 674(b)(iii) provides a Limited POA will provide:
 - Step up in basis on Grantor's death under IRC 1014
 - Grantor Trust Status to apply to Income and Principal allowing use of individual's income tax rates
 - The 121 capital gains exclusion on sale of residence
 - Incomplete gift for tax purpose if both life and testamentary powers are included
 - BUT Medicaid will not consider the trust assets since the assets are no longer available to the Grantor

Tax Issues – Inclusion in Taxable Estate?

- When are trust assets includible in Grantor's estate:
 - Grantor retains a life interest/ life estate, or
 - 5% or plus reversionary interest. IRC 673
 - Or a power of appointment. IRC 674, or
 - Any type of interest which would trigger federal estate tax inclusion (IRC Sections 2036- Retained Life Estate ,2037, 2038- Revocable Transfers)

When Trust Holds Residence

- Oversee the deed signing and deed filing
 - Include life use, residency or tenancy ?
 - Medicaid may consider certain retained interests to be equity in the real property
 - Trustee should preserve and maintain the property as alternate to the life tenant
 - Life tenant can retain any VA or Senior Citizen real estate tax discounts or exemptions.
 - If transferred property is subject to a mortgage?
 - Consult state law relating to due on sale clause. Is resident/borrower/beneficiary protected?

Real Estate Trust Issues

- What happens when Grantor cannot reside in the property? successor residence?
- Designate that real estate must be sold?
- Identify life estate costs and management
- Problematic areas:
 - Multiple beneficiaries, family living on site
 - How to cover maintenance costs

Trust Drafting Cautions

Caution Power of Appointments/ good and bad

- Risk – If individual serving as Trustee and Beneficiary holds the power to administer an irrevocable trust, if it is General Power of Appointment resulting in the trust assets included in the Trustee's estate.
- Solution... Limit lifetime distributions to HEMS or have an independent Trustee make distributions to the Trustee.

Income Tax Issues for Trusts

- Trust can be a separate tax payer
- Irrevocable Medicaid trusts need EIN's. SS number of Grantor should not be used.
- File separate fiduciary tax return (1041) reporting all income whether distributed or accumulated.
- Issue a K-1 to Grantor or all beneficiaries listing the share of income, deductions, and credits distributed
- Double Grantor Trust issues

Drafting Articles on Distributions for Medicaid Recipients

- Grantor may have no access to principal
- Third Party trusts and SNTs can give Trustees discretion to use trust assets for the benefit of the Medicaid Applicant or Recipient
- Sole Benefit and Spendthrift trusts are another form of discretionary trust but use caution in applying trust assets for support and medical care.

How to Provide Access to Principal If Needed... sprinkle provisions

- Establish a class to whom the trustee may distribute principal “sprayees”
 - Call it “Back door access”
 - Avoid minors as sprayees, if trust may need to be amended or decanted
 - Provide for independent trustee or co trustees to allow distribution to family member or individual who is serving as trustee.

Special Trust Clauses

- Default SNT provisions for all disabled
- IRA conduit language
- Addressing Digital Assets and Accounts
- Bequests of Tangible Personal Property
- Combining an Severing Trusts
- Tax appropriation/residuary estate

More Special Trust Clauses

- Consider putting SNT as a default provision for all beneficiaries who may be disabled
- Consider trusts for drafting around minor children and grandchildren.
- Consider inserting flexibility into draft to make amendments or emergency revocation possible if eligibility is needed before the 5 year look back period.

Drafting Distributions at Death

- No particular Medicaid requirement:
 - Income Only Grantor trust may distribute the same as a Last Will. (Option- use a “pour over” will)
 - Can include credit shelter and tax provisions

Exceptions:

- SNT – first party must have pay back
- Sole benefit trust must be made payable to the estate.

Trustee Provisions/Recommendations

- If family member to serve as Trustee provide for appointment of independent Trustee or Co-Trustee.
- Provide for appointment of authorized trustee for decanting
- Provide for successor trustee and resignation options
- Consider whether the Trustee may act individually or serve alone
- Trust protector?

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Administrative Challenges in Using Medicaid Irrevocable Income Only Grantor Trust

- Transfer of assets into and out of Trust
- Sale and purchase of assets within Trust
- What to tell the client about the taxation of the Trust
- Refusal to ask for advice/The “CYA” Letter

Transfers of Assets Into and Out of Trust

- Clients often will not confer with an attorney before the transfer of assets into and out of a Trust
- In engagement/retainer letters, explicitly state who is responsible for transferring assets into the Trust (real property, brokerage accounts, annuities, etc.)
- Engagement/retainer letter spells out that attorney responsible for X number of asset transfers and anything above that or after certain period of time will be an extra cost or done on an hourly basis
- Encourage client to confer with an attorney before transferring assets into or out of Trust after engagement is over so as to not jeopardize any sort of look-back or penalty period

Sale and Purchase of Assets within Trust

- Clients will often times not confer with attorneys before sale of asset in trust and purchase of another one with intention of it being in the trust
- The most common example is sale of real property with intention of proceeds from sale staying inside of the trust
- In correspondence with client remind Client that assets must always be in an account in name of Trust and never in the individual name of the Grantor
- Encourage Client confer with attorneys before sale of asset within Trust so as to not jeopardize any sort of look-back or penalty period

What to tell the Client about the Taxation of the Trust

- It is important we tell Clients what to tell their accountants/CPAs/tax professionals
 - The Trust is drafted in such a way to make the gifts “incomplete” for gift tax purposes, so no gift tax return will be filed at the time of the transfers
 - The Trust is a Grantor trust for all income generated from the trust assets
 - If there is income generated by trust assets (interest and dividends), then each tax year the Trustee will receive 1099 forms for interest and dividends
 - The Trustee will file a federal fiduciary income tax return (Form 1041) and a state fiduciary income tax return for the trust

Refusal to Ask for Advice/The “CYA” Letter

- It is so important to properly draft “CYA” letters before, during, and at the end engagements involving Medicaid planning
- In engagement/retainer letters, explicitly spell out who is responsible for transfer of assets (real property, brokerage accounts, annuities, etc.)
- Engagement/retainer letter spells out that attorney responsible for X number of asset transfers and anything above that or after certain period of time will be an extra cost or done on an hourly basis

Refusal to Ask for Advice/The “CYA” Letter (continued)

- Have Client fill out and sign a questionnaire listing all of Client’s assets in event that an asset is not listed the attorney cannot be held responsible for not planning for an asset left off of the questionnaire
- Encourage Client to confer with attorney before transferring assets into or out of Trust after engagement is over so as to not jeopardize any sort of look-back or penalty period (Not to treat Trust account like another “checking account”)
- Send Client a “disengagement letter” with their fully executed documents at end of engagement

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