January 2015 Vol. 6 No. 1
TAX Stringer℠
A Publication of the NYSSCPA

Tax Stringer Home

Committee Calendar

CPE Schedule

Tax Advocacy

Useful IRS Resources

NYSSCPA Exclusive Member Benefits

Tax Stringer Archive

Submission Guidelines

The Value of Using Irrevocable Trusts in Medicaid Planning

By Louis Lepore, Esq.

If a potential Medicaid recipient desires to qualify for benefits, but yet preserve his or her assets within the family, he or she must gift those assets away. After a 5-year lookback period, the transferred assets are no longer countable for purposes of determining the recipient's eligibility for Medicaid benefits. This raises the question of whether the form of the gift should be an outright gift or a transfer to an irrevocable trust for the benefit of the family member(s).

Prior to the enactment of the Deficit Reduction Act of 2005 (DRA), there was a compelling reason to opt for an outright gift. This is because most transfers to trusts were subject to a 5-year lookback period; whereas, transfers by outright gift were subject to a 3-year lookback period. Thus, the 2 year differential for qualifying for Medicaid benefits made outright gifting a "no-brainer." The DRA, however, leveled the playing field by imposing a uniform 5-year lookback period on all transfers (outright or in trust).

With a uniform 5-year lookback period, the value of gifting assets into irrevocable trusts is worthy of consideration. From an out of pocket perspective, however, outright gifts are certainly more economical. The costs associated with outright gifts such as preparing and recording a deed as well as preparing and filing a gift tax return are relatively low. Moreover, if there are brokerage accounts, financial institutions often provide the transfer documents free of charge. Conversely, creating an irrevocable trust involves the much higher cost of hiring an attorney to draft the trust documents, trustee fees as well as various other accounting and professional fees.

So, given the cost differential, why not keep the Medicaid planning as simple and inexpensive as possible by making outright gifts? The short answer is that in spite of the relatively low transactional costs of outright gifts, in some cases, asset protection, expansive gift and estate planning opportunities as well as potential income tax savings of creating an irrevocable trust may outweigh those savings.

For an individual who desires access to his or her assets and, yet, qualify for Medicaid benefits, a self-settled special needs trust is the only viable option. With such a trust in place, the Medicaid recipient can tap into the trust without jeopardizing his or her Medicaid eligibility. However, upon the death of the recipient, the state must be reimbursed for the lifetime Medicaid benefits provided to the recipient. Only amounts in excess of this reimbursement may be distributable to the recipient's family.

Finally, third parties contemplating making a gift or bequest to an individual who is or may potentially be eligible for Medicaid benefits, creating an irrevocable third party special needs trust is a sound option. Whereas, a direct gift to the individual would be a countable asset that would affect the individual's eligibility, the corpus of a special needs trust is not a countable asset. Funds from the special needs trust are available to supplement the individual's needs that are not covered by Medicaid.

Depending on the nature of the trust, the key benefits of gifting assets to a properly drafted in trust include:

- Asset protection of the trust corpus from future creditors of beneficiaries
- Shifting the tax benefit of the Section 121 exclusion of capital gain upon sale of the settlors' principal residence to a trust

- Income tax benefit of the fair market value step-up basis with regard to the assets transferred to the trust upon the death of the settlor.
- Ability to make trust assets noncountable for beneficiary's eligibility for means-based governmental benefits, such as Medicaid and Supplemental Security Income (SSI)
- Ability to determine who will receive any trust assets after the death of the initial beneficiary
- Possible elimination of requirement to file a federal gift tax return with regard to the transfer of assets into the trust.

In sequence, each of these potential benefits is discussed below. The availability of these potential benefits depend on the design and drafting of the trust. **None are automatic or inherent in every trust. Thoughtful planning and careful drafting is necessary to take advantage of the benefits available. Thus, it is important to understand how and why each benefit comes about.**

Asset Protection from Future Creditors of Beneficiaries

Unlike an outright gift to an individual that is reachable by the individual's creditors, a transfer of assets into a trust for the benefit of that individual can provide asset protection for those assets. This is accomplished by including a spendthrift provision in the trust that essentially limits the distribution of income or principal to the beneficiaries to the sole discretion of the trustee. Because of this limitation, the underlying trust assets are not subject to attachment, foreclosure, garnishment, or a laundry list of undesirable actions by the creditors of the beneficiaries.

Shifting the Tax Benefit of Section 121 Exclusion of Capital Gain on Sale of Principal Residence to the Trust

Pursuant to section 121 of the Internal Revenue Code (Tax Code), up to $250,000 of capital gain from the sale of the taxpayer's principal residence is tax-free (up to $500,000 for a married couple filing jointly). To qualify for this tax benefit, the taxpayer must have owned and lived in the residence in at least two of the past five years before the sale (only one of the past five years if the taxpayer had to be moved to a nursing home). So, if a principal residence is gifted outright, the donee would have to meet the ownership and living in the residence requirements in his or her own right to take advantage of the exclusion. Thus, if upon receiving the principal residence, the donee immediately sold it, all of the capital gain would taxable.

Conversely, if the irrevocable trust is treated as a grantor trust for income tax purposes, the tax-free exclusion would apply. Thus, if upon transferring the principal residence to a "grantor trust," it was immediately sold, the Section 121 exclusion could potentially shelter up to $500,000 of capital gain. Because many seniors have owned their homes since the late 1940s, 1950s or 1960s, it is likely that a huge amount of appreciation in value has occurred since then. Due to these potentially significant tax savings, a transfer to a trust would be more beneficial than an outright gift.

Income Tax Benefit of a Fair Market Value Step-Up of Basis

The tax benefit of a fair market value step-up basis is another reason why a transfer of property to an irrevocable trust treated as a grantor trust is preferable to an outright gift. Under Section 1015 of the Tax Code, the donee's basis in a gifted asset is the same as the donor's basis in the asset. So, the donee's basis in stock originally purchased by the donor for $10,000 (cost basis) with a date of gift fair market value of $20,000 would be the donor's $10,000 cost basis. On the other hand, under Section 1014 of the Tax Code, the basis of property gifted to a beneficiary that was included in the donor's taxable estate for federal estate tax purposes, is the date of death fair market value. So, based on the facts in the prior example, the beneficiary's basis in the gifted stock would be $20,000.

In order to secure a fair market value step-up in basis, appreciated property (fair market value is greater than basis) should be transferred to an irrevocable trust treated as a grantor trust for federal estate tax purposes. Therefore, if the trust retains the appreciated property until the settlor's death, the asset would be included in the settlor's taxable estate and the asset's basis would step-up to the date of death fair market value. Thus, capital gain from the subsequent sale of the asset by the trust or the beneficiary of the trust would be minimized or eliminated. Moreover, with a federal estate (tax-free) exemption of $5,340,000 (in 2014), the estates of most Medicaid planning clients will never exceed that amount. So, in light of a high federal estate tax exemption and fair market step-up of basis, a transfer of appreciated property to a grantor trust provides potentially significant tax savings with no federal estate tax liability. **A Limited Power of Appointment retained by the settlor can accomplish this setup in basis. Other provisions can also cause taxable estate inclusion.**

Ability to Make Trust Assets Noncountable for Beneficiaries' Medicaid or SSI

Unfortunately, an outright gift or bequest from a donor, such as a parent, to a disabled donee who was eligible or soon would have been eligible for means-based governmental benefits may cause the donee to become ineligible for those benefits. In that case, eligibility for those benefits would be postponed until the gifted assets are totally consumed for the donee's care. One way to view this outcome is as an indirect gift or bequest to the governmental benefit program that caused the disabled person to become ineligible for his or her benefits for a period of time. This is generally considered to be poor planning.

Better planning is make the gift or bequest to an irrevocable "third party special needs trust" for benefit of the disabled beneficiary. By doing so, the gifted assets are treated as noncountable, and, thus, do not affect eligibility. The assets in the trust are used to enhance the living conditions of the disabled beneficiary by paying for things that the governmental benefits do not pay for.

If a disabled person receives an outright gift or bequest and later becomes disabled, depending on the age of the disabled person, it may be possible to establish a "self-settled special needs trust" for the disabled beneficiary. Upon the death of the beneficiary, the trust (funded with the disable person's assets) must contain a payback provision that requires any remaining trust assets to be applied to reimburse the state for up to the full amount of Medicaid benefits received by the beneficiary. Only trust assets in excess of the state reimbursement may be passed on to other beneficiaries such as family members. The payback provision requirement is Congress's "quid pro quo" – the balancing deal that makes it fair for the disabled person's otherwise disqualifying assets to be set aside in a self-settled special needs trust for his or her use to supplement but not replace the governmental benefits.
.

Ability to Decide Which Beneficiaries Will Inherit Upon Settlor's Death

The retained Limited Power of Appointment referred to above (sometimes called a Special Power of Appointment) preserves for the settlor the power to decide who within a designated class of recipients will receive the benefits of the trust, how much they will receive, and in what way they will receive it. The class of potential recipients can be as broad as everyone in the world except the settlor and his or her creditors, and the settlor's estate and its creditors. Most often, however, the class of potential appointees consists of the settlor's descendants, certain other relatives or in-laws, and/or certain charities. Such a Limited Power of Appointment (LPOA) can determine whether the trust is a grantor or nongrantor trust, as well, so the specific language of the LPOA must be crafted carefully with regard to the grantor trust rules of the Tax Code. As an aside, a power of appointment is sometimes referred to jokingly as a "power of disappointment" because it truly retains for the settlor or other power holder the power to disinherit someone who acts badly.

Ability to Determine Successor Beneficiaries

Another reason to transfer assets to an irrevocable trust rather than as an outright gift is the ability to provide for successor beneficiaries. If a gift or bequest passes outright, the recipient rather than the donor has control through lifetime consumption of assets and income as well as the testamentary ability to determine who will receive whatever is left. Additionally, as discussed above, an outright gift is also attachable by the beneficiary's creditors or predators.

On the other hand, if the donor creates an irrevocable trust, the donor, not the initial beneficiary, determines which beneficiaries are to receive the remainder of the trust. For example, the donor may decide to limit successor beneficiaries to blood descendants and their spouses, and/or certain charities. This planning opportunity is available regardless of the initial size of the gift or bequest – if a modest amount of funds are left in trust, there may nevertheless be a remainder to pass to a successor beneficiary or even another successor beneficiary. This sounds like a "dynasty trust" and it actually is, even though it is of modest size. The point is that by use of an irrevocable trust, the donor has the option to decide who the possible recipients will be, and even to grant limited powers of appointment to the named recipients in order to give them some control as well.

Analysis of Need to File a Federal Gift Tax Return for Year of Funding an Irrevocable Trust

A goal of many planners in the design of irrevocable trusts is to make the initial trust-funding gift(s) "incomplete" for tax purposes. This is because only "completed" gifts require the filing of a gift tax return. So, the goal is to structure the transfer in a way that does not require the settlor to file a federal gift tax return for the year(s) of the funding transaction(s), assuming that the settlor made no other "taxable gifts" in any such year.

Whether a transfer to an irrevocable trust is considered a "completed gift," thus requiring the filing of a gift tax return is a complex issue that depends on the extent to which the grantor reserves any power over the ultimate disposition of the transferred property. Due to a lifetime gift tax exemption of $5,340,000 (in 2014), however, even if a gift tax return is required, it is unlikely any gift tax will be owing. On the other hand, even if no gift tax is due, it is important to file a gift tax return when one is required. We are happy to assist you in making this determination.

Conclusion

In spite of potentially higher transactional costs, the above discussion **demonstrates** that using an irrevocable trust in Medicaid planning can provide significant benefits beyond the transactional cost savings of outright gifting. Those benefits may include asset protection, income tax savings, converting countable assets into noncountable assets, broader estate and gift planning opportunities as well as not being required to file a gift tax return.

Portions of this article originally appeared in the November 2014 issue of "The Planner," Copyright, The Law Office of Louis P. Lepore," reprinted with permission.

***Louis Lepore, Esq.,** is an attorney admitted to practice law in New York, New Jersey and Florida. He has a B.S in accounting and an LLM in taxation. He has vast experience in tax matters, over ten years of experience working for the New York State Department of Taxation and Finance, and is a member of the National Academy of Elder Law Attorneys. His practice areas include estate planning, elder law/Medicaid asset protection and probate and estate administration. He can be reached at louis@leporelaw.com.*

Search | Site Map | Become a Member | CareerBank | Press Room | Classifieds | Contact Us

Copyright 2015 New York State Society of Certified Public Accountants. Legal Notices

The views expressed in articles published in *Tax Stringer* are those of the authors and not necessarily those of *Tax Stringer*, unless otherwise indicated. Articles contain information believed by the authors to be accurate as of original publication. The reader should not construe the content included in *Tax Stringer* as accounting, legal or other professional advice. If specific professional advice or assistance is required, the services of a competent professional should be sought.