

The Use of Irrevocable Trusts in Medicaid Planning

Probate and Pumpernickel
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What We Will Cover

- Pros and Cons of Using MAPTs
- Rules That Can Never Be Broken
- Choice of Trustee
- Grantor Trust Status
- Choice of Lifetime Beneficiaries
- Distribution Standards to Lifetime Beneficiaries
- Trust Protectors
- Funding
- Helping Clients to Understand the Value



Why Use a Medicaid Asset Protection Trust?

To Help Clients Protect Assets
Before a Crisis Strikes
(Proactive Planning)

Why Use a MAPT?

- As an Alternative to Outright Gifting in a Crisis Planning Case
 - Many downsides to outright gifting
- Tax Advantages
 - Protection of 121 Exclusion on capital gains
 - Step up in basis on trust assets at grantor's death

Medicaid Asset Protection Trusts – Pros

- Protect homes and highly appreciated assets from
 - Being considered an available resource
 - Estate recovery (some jurisdictions allow; depends on expanded def. of estate)
- Grantor can retain right to receive income.
- Income can be taxed to the grantor and not children.
- House can be sold and proceeds held in the trust during lifetime without impacting Medicaid.
- Funds can be used for grantor's benefit through distributions to lifetime principal beneficiaries.
- Beneficiaries receive step-up in basis, rather than carryover basis.

Medicaid Asset Protection Trusts – Cons

- 5-Year Lookback Period Applies
 - Clearly an advance planning tool
- It's Irrevocable!
 - Trust Code permits revocation of trust with consent of grantors, trustees and beneficiaries
- No Principal to Grantor

Rules That Can Never Be Broken

Rule #1 – Watch out for the “any circumstances” test!

- Neither the Grantor nor the Grantor’s spouse may have access to principal, whether directly or indirectly.
 - *Doherty* case from Massachusetts is a good example of indirect access. *74 Mass App. Ct. 439 (March 4, 2009)*
 - Trust considered as a whole, allowed distributions to grantors in certain circumstances
 - “Due to the unforeseeability of grantor’s future needs ...”
 - Power to veto sale of home
 - Statement that government benefits may not be sufficient to meet care needs and trustee authority to invade principal to make up difference

No Access to Principal

Rule #2 – Termination Provision

- If a termination provision is given, make sure only principal beneficiaries receive the assets upon termination – NOT GRANTORS.

Rule #3 – Adjustments between Principal and Income

- If Grantor is receiving income, do not allow the Trustee to make principal and income adjustments.

Rules That Can Never Be Broken

Rule #4 - The grantor's access to principal cannot be based on a triggering event.

- For example, “Trustee may distribute principal to the grantor until the grantor enters a nursing home at which time the trustee may no longer distribute principal to the grantor.”
- *OBRA 93* eliminated the use of “trigger trusts” in *inter vivos* trusts.
- Still allowed in testamentary trusts

Rules That Can Never Be Broken

Rule #5 - In a self-settled trust, the grantor cannot give the trustee discretion to distribute principal back to the grantor.

- With self-settled trusts under *42 USC 1396p*, the trustee's discretion will be exercised in favor of the grantor and all assets will be available to the grantor.

Outright Gifting to Children vs. MAPT

Options

- Self-settled trust using the client's money to fund, or give the money to a child/children

- Advantages of transferring to trust vs. outright gifting
 - Fiduciary/trustee
 - “oversight/participation” by other children
 - “oversight/protections” by appointment of Trust Protector

- Hazards of the gift to kids
 - Divorce, bankruptcy, creditors, lawsuits, gambling, alcoholism, etc.

Completed Gift?

Included Special Power of Appointment

- Incomplete gift for tax purposes
- Basis step up

No SPOA

- Completed gift for tax purposes
- No basis step up

Regardless – Transfers to the trust are completed gifts for Medicaid purposes.

42 USC 1396p – Transfers by Individual or Spouse

(d) Treatment of trust amounts

(1) For purposes of determining an individual's eligibility for, or amount of, benefits under a State plan under this subchapter, subject to paragraph (4), the rules specified in paragraph (3) shall apply to a trust established by such individual.

(2)

(A) For purposes of this subsection, an individual shall be considered to have established a trust if assets of the individual were used to form all or part of the corpus of the trust and if any of the following individuals established such trust other than by will:

(i) The individual.

(ii) The individual's spouse.

(iii) 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.

(iv) A person, including any court or administrative body, acting at the direction or upon the request of the individual or the individual's spouse.

Statement of Intent

Section 1.05 Statement of Our Intent

We are creating this trust as part of our estate plan to ensure efficient management, administration and protection of the trust assets for our beneficiaries. It is our express intent that the principal and income of this trust will not be available to either of us for any purpose, including Medicaid.

In order to maximize the benefit to our trust beneficiaries, we give our Trustee broad discretion with respect to the management, distribution and investment of assets in our trust. Our objective is that the assets in this trust will not be subject to the claims of any beneficiary's creditors.

All provisions of this agreement shall be construed so as to accomplish our objectives. Any beneficiary has the right at any time to release, renounce or disclaim any right, power or interest that might be construed or deemed to defeat our objectives.

Choice of Trustee

Who Should Trustee Be?

- Grantor and/or spouse should not serve as trustee unless you know your state allows it.
- Preference – don't do it!

Independent vs. Interested Trustee

- Definition of “independent trustee”
- Someone who is not an interested trustee
- Generally, an **independent trustee** is a person who is not the grantor of the trust, or a related or subordinate party (within the meaning of *Section 672(c)* and the applicable regulations) to the grantor or the grantor's spouse, and is not a beneficiary of the trust.

Definition of “Related or Subordinate”

- IRC 672(c)

(c) Related or subordinate party

For purposes of this subpart, the term “related or subordinate party” means any nonadverse party who is—

- (1) the grantor’s spouse if living with the grantor;
- (2) any one of the following: The grantor’s father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

For purposes of subsection (f) and sections [674](#) and [675](#), a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

Naming the Initial Trustee

Benefits of having an independent trustee:

- May distribute to any lifetime beneficiary for any purpose with no adverse tax consequences to the trustee
- Completely discretionary distributions
 - Protects a lifetime beneficiary who may have creditor problems

Naming the Initial Trustee

- Often difficult to find someone who is independent (has no beneficial interest in the trust)
- Sometimes competes with our desire to name a trust protector who must also be an independent party
- If there is not an independent trustee named, you can provide for the appointment of a special independent trustee.

Special Independent Trustee

Section 2.09 Appointment of Independent Special Trustee

If for any reason a Trustee of any trust created under this agreement is unwilling or unable to act with respect to any trust property or any provision of this agreement, or if a provision of this agreement requires an Independent Trustee to act, then the Trustee or Trust Protector shall appoint, in writing, a corporate fiduciary or an individual to serve as an Independent Special Trustee as to such property or with respect to such provision. The Independent Special Trustee appointed shall not be related or subordinate to either of us while living or to any beneficiary of the trust within the meaning of Section 672(c) of the Internal Revenue Code. The appointing party may revoke any such appointment at will.

An Independent Special Trustee shall exercise all fiduciary powers granted by this agreement unless expressly limited elsewhere in this agreement or by the appointing party in the instrument appointing the Independent Special Trustee. An Independent Special Trustee may resign at any time by delivering written notice of resignation to the appointing party. Notice of resignation shall be effective in accordance with the terms of the notice.

Under no circumstances may either of us serve as an Independent Special Trustee.

Another Option – The Distribution Trustee

- Only responsible for making discretionary distributions for any purpose
 - Options
 - ✓ during lifetime of grantor only
 - ✓ only at death
 - ✓ or both
- No other trustee may make distributions.
- Must meet the definition of independent trustee

What About Co-Trustees?

- Practical issues if they must act together
- Can act as checks and balances

An Important Restriction – Unitrust

Electing Unitrust Status

- If grantor is receiving income,
 - Always restrict the trustee from electing unitrust.
- Even if no income is being paid to the grantor, it is a good idea to choose (see Mass. decisions).

Unitrust Status

By choosing to restrict electing unitrust status, the following language comes into the trust:

Section 6.12 No Power to Elect Optional Unitrust

Notwithstanding any provision of this agreement or state law to the contrary, the Trustee may not elect to apply the optional unitrust provisions under California law to any Supplemental Needs Trust administered under this Article.

Another Important Restriction

Adjusting principal and income and requiring Trustee to follow your state's Principal and Income Act

- We don't want the trustee to mix principal with income if the grantor has an income right.
- We don't want Medicaid to deem the mere existence of this right to allocate means that grantor has access to principal.

What Tax Advantages Are We Trying to Gain With a MAPT?

- Inclusion of Trust Assets in the Grantor's Estate for Estate Tax Purposes (Usually)
- Ensuring the Grantor (and Spouse) Can Qualify for the IRC 121 Exclusion on Capital Gain if Their Home is Owned by the Trust and is Sold
- Maintaining Any Property Tax Exemptions on the Home
- Making Sure Income Generated by Trust Assets is Taxed at the Grantor's Individual Tax Rate
 - Rather than the Trust's

Inclusion of Trust Assets in the Grantor's Estate for Estate Tax Purposes

- In general, when the grantor gives up the right to access and right to control of property, it is no longer included in his/her “estate” for purposes of calculating any tax due at the grantor's death.
- However, when this happens, the assets in the trust will not get stepped-up basis to fair market value at the time of the grantor's death.

How Do We Make Sure the Assets Can Get a Step Up in Basis?

- The grantor must retain some incident of control over the trust assets that is sufficient enough to pull them back into the estate at the death of the grantor.
- Testamentary limited power of appointment – allows the grantor to change beneficiaries in a writing that is effective upon the grantor's death.

The Limited Power of Appointment and Basis

Why is it desirable?

- Trust assets in an individual trust receive a step-up in basis at the death of the grantor.
- Causes Estate Tax Inclusion

Grantor Trust Status

- Normally when talking about trying to achieve grantor trust status, we are trying to achieve certain tax advantages either **over income, principal or both.**
- Treasury Regulations Section 1.671-2(e)(1) says,
 - "[A] grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property to a trust."

Grantor Trust Status

- Generally, a grantor is the person who creates and funds a trust and retains powers that cause the income of the trust to be attributed to him or her.
- Under most circumstances, a grantor also includes the grantor's spouse.

Grantor Trust Status

We want grantor trust status over income and principal for several reasons:

- We want **income** generated by trust assets to be taxed at the grantor's individual tax rates rather than high trust tax rates.
- We want **capital gains** taxed at the rate for individuals.
- We want to preserve the **IRC Section 121 exclusion** on capital gain if the home is sold.
- We want to maintain **property tax exemptions**.

Grantor Trust Status

- There are a number of grantor trust rules in *IRC Sections 671-678*.
- We only have to be concerned with 2, as they provide us with the tax benefits we are looking for.

Grantor Trust Status

Power to add (charitable) beneficiaries

- *IRC 674(b)(5)*, Power to Distribute Corpus
 - May be held by grantor, trust protector or other non-adverse individual

Power to substitute assets of equivalent value

- *IRC 675(4)(C)*, General Powers of Administration
 - May be held by the trust protector or nonadverse individual

Grantor Trust Status

- Just retaining an income right is not enough to achieve our goals.
- If a grantor has only an income interest in the trust, then only those items relating to trust **income** will be taxable to the grantor.
- If the grantor has only an interest in the principal, then the grantor may only recognize income, deductions and credits that are attributable to **trust principal**.

Choice of Lifetime Beneficiaries

- These are the only individuals who will be able to accept a distribution from the trust during the grantor's lifetime.
- If the grantor needs something, it is the hope that the lifetime beneficiary (usually children) will either use their own money or request a trust distribution.

Lifetime Beneficiaries

Obligations of the Lifetime Beneficiaries

- Never obligate the lifetime beneficiaries to take distributions for mom or dad's benefit.
- While often children, they can also be any other individual the grantor wishes.
- Must not obligate the lifetime beneficiaries to use the trust funds for the grantor's needs.

Lifetime Beneficiaries

Options

- Equal or unequal distributions
- May be tied to needs or silent as to needs
- Staggered?

Distribution Standards

Under what circumstances can a lifetime beneficiary receive trust principal?

- Instructions to the trustee needed
- Consider -
 - Interested trustee and GPOA issue
 - Creditors of lifetime beneficiaries

Distribution Standards

Options

- Ascertainable Standards (shall – HEMS)
- Discretionary Ascertainable Standards (may - HEMS)
- Any purpose if independent, otherwise ascertainable standards
- Any purpose if independent, otherwise discretionary ascertainable standards
- Any purpose if independent, otherwise none
- Any purpose

Trust Protectors

- Began in the offshore planning area
- States have begun to enact statutes governing this area.
- What is the trust protector's job?
 - Depends on who you ask

How We Describe a Trust Protector

Section 2.11 Provisions for Trust Protector

The function of the Trust Protector is to direct our Trustee in matters concerning the trust, and to assist, if needed, in achieving our objectives as manifested by the other provisions of our estate plans.

In order to serve, any Trust Protector named or appointed under this Section must be a corporate fiduciary or an individual who is not related or subordinate to a transferor or any beneficiary within the meaning of Section 672(c) of the Internal Revenue Code.

Trust Protector

Who should be Trust Protector?

- Trust Protector must be an independent party.

Trust Protectors

The Trust Protector may serve several important functions:

- Removal and replacement of Trustee (may be limited)
- Appoint an independent special trustee
- Power to amend the trust
- Power to terminate the trust
- Power to examine trust records

Removal of Trustee

- The trust protector may be given authority to remove any trustee.
- Possible exception:
 - A descendant of the grantor
 - Is this a good idea?

Fiduciary vs. Non-fiduciary Capacity

Non-fiduciary Capacity

(g) Good Faith Standard Imposed

The authority of the Trust Protector is conferred in a nonfiduciary capacity, and the Trust Protector is not liable for any good-faith act, omission, or forbearance. The Trust Protector will be reimbursed promptly for any costs incurred in defending or settling any claim brought against the Trust Protector acting in the capacity of Trust Protector, unless it is conclusively established that the act, omission, or forbearance was motivated by an actual intent to harm the beneficiaries of the trust or was an act of self-dealing for personal benefit.

Fiduciary vs. Non-fiduciary Capacity

Fiduciary Capacity

(g) Good Faith Standard Imposed

The authority of the Trust Protector is conferred in a fiduciary capacity, however the Trust Protector is not liable for any good-faith act, omission, or forbearance. The Trust Protector will be reimbursed promptly for any costs incurred in defending or settling any claim brought against the Trust Protector acting in the capacity of Trust Protector, unless it is conclusively established that the act, omission, or forbearance was motivated by an actual intent to harm the beneficiaries of the trust or was an act of self-dealing for personal benefit.

No Duty to Monitor

You may wish to include a proactive statement regardless of fiduciary vs. non-fiduciary –

(I) No Duty to Monitor

The Trust Protector has no duty to monitor or supervise any Trustee or trust created under this agreement. Further, the Trust Protector has no duty to be informed as to the acts or omissions of others or to take any action to prevent or minimize loss. Any exercise or non-exercise of the powers and discretions granted to the Trust Protector is in the sole and absolute discretion of the Trust Protector.

Trust Protectors

- Many states do not have statutes regarding trust protectors.
- A few that do -
 - Alaska
 - Michigan
 - Idaho
 - Missouri

Should the Drafting Attorney Serve?

- Does your malpractice carrier insure your actions?
- Are you prepared to serve in a fiduciary capacity?
- Weigh pros and cons

Client Issues

- Funding
- Talking to clients about this type of planning

Funding

- In all states but California, the goal is to get all assets into the trust within the same month.
 - Is your office prepared for this step?
 - Who is managing the workload?

- We want to get the “look-ahead” period of 60 months started as soon as possible.

Funding

How much should go into the MAPT?

- How much does the client want to protect?
- How much does the client need to live on?
- What type of assets does the client have?
 - IRAs – can't go into the MAPT
- What is the client's need for income?
 - Where is their income coming from now?

The Funding Process – Do You Have One?

- With irrevocable trust funding, it is important for the attorney to be involved.
- All assets going into the trust must be properly identified, and letters drafted to each company requesting a change of title to the asset.
- You will also need confirmation back from each company when the change of title has been accomplished.

Funding Process

- It is important to have one person overseeing the entire process to make sure no assets are overlooked.
- A step-by-step checklist is a powerful tool to ensure cases are completed timely and correctly.
- Routine check-ins on finishing client work keep everyone on task.

After Funding

Practice Development Letters*

- To all third party professionals involved
- To potential decision-makers
- To family

Closing letter for malpractice insurance

- With a maintenance plan
- Without a maintenance plan

*With client consent

Talking to Clients About Irrevocable Trusts

Before You Are Hired

- You aren't talking about irrevocable trusts, you are only talking about asset protection.
- Depending on the reason they came in, you may have to change the conversation to focus on what could happen if their health declines.
- Use easy terms to describe how you can protect their assets.

Talking to Clients About Irrevocable Trusts

After You Are Hired

- You begin discussing how to design the trust.
- The client's fear of losing control is only an issue if you make it one.
- Remind them that their lifestyle will not change – we are leaving enough assets outside the trust for them to live comfortably.

Talking to Clients About Irrevocable Trusts

- When planning early (proactive planning), it is as much about asset protection as it is about making sure our clients have choices if a health care crisis strikes.

Thank You!

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