THE USE OF AN IRREVOCABLE TRUST IN MEDICAID PLANNING

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Federal law provides that “an individual shall be considered to have established a trust if assets of the individual fund 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 individual's spouse, and (iv) a person including any court or administrative body, acting upon the direction or on request of the individual or individual's spouse.”

Once it is established that the trust meets the aforestated test, the impact on Medicaid eligibility will differ depending on whether the trust is revocable or irrevocable.

The corpus (principal) of a revocable trust continues to be considered a resource "available" to the individual for purposes of the resource test for Medicaid eligibility, and payments to or for the benefit of the individual will be treated as income, and thus, be subject to income restrictions for eligibility.

However, the assets transferred to an irrevocable trust will not be considered an available resource for Medicaid eligibility once the assets transferred to the trust fall outside of the 5 year look back period for Medicaid. However, the income generated by the trust will be deemed available to the individual for purposes of Medicaid eligibility.

PLANNING OPTIONS AVAILABLE TO PRESERVE REAL PROPERTY FOR THE FAMILY

Even before the enactment of the DRA, the decision to transfer the primary residence raised a number of important issues and concerns for both the attorney and client, for example; gift taxes, potential capital gains tax consequences and, of course, the transfers impact on the Medicaid eligibility of the senior. However, once the decision was made to transfer the primary residence to someone other than a spouse, for Medicaid planning purposes, there were generally three primary planning options available:

(a) Outright Transfer of the Residence Without the Reservation of a Life Estate.

Perhaps the least desirable option available, as the transferee of the property will receive the transferor's original cost basis in the property(original purchase price /value upon receipt plus capital improvements), and the outright transfer is a completed gift subject to gift taxes. For Medicaid eligibility purposes and pursuant to the DRA, the outright transfer of the residence would be subject to a 60 month look back period, and if the transfer of the residence was made within the look back period, the ineligibility period created would not commence until the individual was in the nursing home had applied for Medicaid and would otherwise be eligible for Medicaid, but for the transfer.

For example, the formula used to calculate the period of ineligibility created by a non-exempt transfer of assets would be to take the fair market value of the property transferred, and divide said amount by Medicaid Nursing Home Rate for County of Applicant's Residence ($500,000 ÷ 11,135 Westchester County rate equals approximately 44.90 months of ineligibility). If Medicaid is needed within the 60 month look back period, the period of ineligibility would not commence until the applicant was receiving institutional care (in a nursing home), had applied for Medicaid and would have been approved but for the transfer made.

Additionally, from a tax perspective the use of an outright transfer of the residence results in the transferor losing the Internal Revenue Code ("IRC") §121(a) principal residence exclusion for capital gains of $250,000 (single person) or $500,000 (married couple). However, if the transferee owns and resides in the premises for two out of the five he or she will be able to use said principal residence exclusion. Any Veteran's, STAR and Senior Citizen's Exemptions are also lost. It is necessary to obtain a fair market value appraisal of the premises gifted for purposes of calculating the federal gift tax credit ($5,340,000 per person) utilized by the transfer.

(b) Transfer of the Residence with the Reservation of a Life Estate

If the transfer was made within the Medicaid look back period (60 months), the period of ineligibility would not commence until the applicant was receiving institutional care in a nursing home and was otherwise eligible for Medicaid, but for the transfer made. Thus, a transfer of real property by deed with a retained life estate will also require that the transferor not apply for Medicaid within the look back period to avoid an onerous period of ineligibility.

Pursuant to §2036(a) of the IRC, the transfer of a residence with a retained life estate permits the transferee of the residence to receive a full step up in his or her cost basis in the premises upon the death of the transferor, to its fair market value on the transferor's date of death. This occurs because the residence is includible in the gross taxable estate of the transferor upon his or her demise. This, of course, presumes the existence of an estate tax upon the death of the transferor. A "life estate", pursuant to §2036(a) of the IRC, is the possession or enjoyment of, or a right to the income from the property or the right either alone or in conjunction with another to designate the persons who shall posses or enjoy the property or income thereof.

The most significant problem in utilizing a deed with the reservation of a life estate results if the premises are sold during the lifetime of the transferor. A sale during the transferor's lifetime will result in (a) a loss of the step up in cost basis, thus, subjecting the transferee to a capital gains tax on the sale with respect to the value of the remainder interest being sold (difference between transferor's original cost basis, including capital improvements, and the sale price), and (b) the life tenant pursuant to Medicaid rules is entitled to a portion of the proceeds of sale based on the value of his or her life estate. This portion of the proceeds could be significant and will be considered an available resource for Medicaid eligibility purposes, thus, impacting the transferor's eligibility for Medicaid or being an asset against which Medicaid may have a lien. The existence of the possibility that the premises may be sold prior to the death of the transferor(s) poses a significant detrimental risk that needs to be explored in great detail with the client.

If for tax planning purposes it is prudent to make the gift an "incomplete gift" for gift tax purposes, the reservation of a limited testamentary power of appointment to the Grantor should be considered.

It should be remembered that §2702 of the IRC values the transfer of the remainder interest to a family member at its full value without any discount for the life estate retained. Retention of a life estate falls within one of the exceptions of §2702.

If the transfer does not fall within §2702 of the IRC, or if one of the available exceptions applies (e.g. treated as a transfer in trust to or for the benefit of), calculation of the life estate is performed pursuant to IRC §7520, and the tables for the month in issue need to be consulted to determine the correct tax value of the remainder interest.

Pursuant to IRC §2702 if the homestead is transferred to a non-family member, the use of a traditional life estate will result in a completed gift of the remainder interest. It should also be remembered that the gift of a future interest (remainder or reversionary interest) is not subject to the annual exclusion of $12,000 per donee for the year 2006.

(c) Transfer to an Irrevocable Income Only Trust a/k/a ("Medicaid Qualifying Trust").

From a purely Medicaid Planning perspective, the use of the Irrevocable Income Only Trust in my opinion may be the most logical option. As previously explained, irrespective of the fair market value of the residence transferred to the Trust, the period of ineligibility will effectively be five years (60 months). However, the properly drafted Irrevocable Income Only Trust will allow the residence to be sold during the lifetime of the transferor with little or no capital gains tax consequences, as it is possible to utilize the transferor's personal residence exclusion of up to $500,000 if married, and $250,000 if single, by reserving in the trust instrument the power to the Grantor(s) in a non-fiduciary capacity and without the approval and consent of a fiduciary to reacquire all or any part of the trust corpus by substituting property in the trust with property of equivalent value. The Grantor(s) will be considered the owner for income tax purposes. See IRC §675(4). Additionally, the transfer to the Trust can be structured to allow the transferee to receive the premises with a stepped up cost basis upon the death of the transferor, through the reservation of a life income interest (life estate) to the Grantor. §2036(a) of the IRC.

While the lengthy Medicaid ineligibility period must be appropriately considered, however, the tax advantages and the continued flexibility of being able to sell the premises during the transferor's lifetime without income tax consequences, in my opinion, makes the Irrevocable Income Only Trust an ideal option in most circumstances.

The transfer of the residence to the Irrevocable Income Only Trust is a taxable gift of a future interest, no annual exclusion available. Full value of premises reported on gift tax return. If value over $5,340,000 gift taxes are due.

If a limited power of appointment is retained, the gift to the trust is incomplete. Treasury Reg. 25.2511-2(b). No gift tax return is technically required, however, it is advisable to review with an accountant the filing of a gift tax return for informational purposes.

On the death of the Grantor of the Trust, the date of death value of all assets in the trust will be included in the Grantor's taxable estate pursuant to §2036(a) of the IRC, as a result of the life income interest retained by the Grantor.

Inclusion in Grantor's estate will result in a full step up in cost basis for all trust assets pursuant to §1014(e) of IRC, assuming an estate tax is still in existence at the time of the Grantor's demise.

The new law more than anything else severely punishes those who procrastinate in planning for their long term care. Whether it be the transfer of assets to an Irrevocable Income Only Trust, use of a deed with a life estate or the purchase of long term care insurance, it is clear that through advance planning one can limit the extent of his or her exposure to the costs of long term care.