By Bernard A. Krooks & Jonathan G. Blattmachr

The Medicaid Trust

Help your client pay for costly long-term care without losing significant personal assets

The cost of long-term health care continues to spiral and insurance companies continue to cover fewer and fewer long-term needs. As a result, it's important for advisors to help their older clients plan for long-term care while protecting their clients' assets. That's where a Medicaid trust comes into play as an effective asset protection strategy: It allows your client to use Medicaid assistance to cover the costs of long-term care, without the loss of significant personal assets.

Before you create a Medicaid trust, however, you should consider having your client retain a power to control the ultimate destiny of the trust property when he dies. That control will prevent any taxable gift from being made when the trust is created. Your client's retained power to control his trust's destiny also will ensure that the trust property will be eligible for carryover basis adjustments if your client dies in 2010.

Under a Medicaid trust, the individual who creates the trust (the grantor) typically retains the right to income for life. For many seniors, this retention right is important to maintain their standard of living. If the trust is created at least 60 months before applying for Medicaid benefits, the existence of the trust will not preclude the grantor from qualifying for Medicaid benefits and the entire trust corpus may be protected from the cost of long-term care. If the trust is created within a 60-month period, then a portion of the trust may still be protected from the cost of long-term care, depending on a client's circumstances.

Tax Considerations

Although a Medicaid trust typically is created for asset protection, there are tax issues to consider, too. One issue is whether a taxable gift will be made when the trust is created. Typically, the interest in a trust retained by the grantor is not treated as a gift for gift-tax purposes. But the interest in a trust that is not retained by the grantor can be a gift. That gift may use all or part of the grantor's lifetime gift tax exemption or result in gift tax being due. Under Internal Revenue Code Section 2702, a gift made to successor beneficiaries (that is, the persons to whom the trust assets will be paid when the grantor dies) can be deemed to be equal to the entire value of the assets transferred to the trust. The interest (typically, the right to all of the trust's income) retained by the grantor is ignored in valuing the gift to the successor beneficiaries if those successors are members of the grantor's family (including the grantor's spouse, descendants and siblings and descendants of the spouse).

For 2010, there's another onerous tax rule: Under IRC Section 2511(c), an individual will be treated as making a gift, regardless of the control he retains over a trust, if the trust is not a grantor trust in its entirety. Where an individual retains only the right to income but neither eligibility to receive nor the right to control the ultimate disposition of the trust principal, only the income portion and not the principal portion of the trust might be treated as a grantor trust—and that also means the interests in the trust may constitute a taxable gift.

There are also estate-tax inclusion issues to consider. The retention of the right to the income from a

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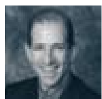

trust causes the entire trust to be included in the gross estate of the grantor at his death for federal estate-tax purposes under IRC Section 2036(a)(1). That is to say, making a taxable gift in setting up a trust doesn't reduce the estate tax burden on the property at death, although it may result in an overall reduction of taxes if the gift tax is paid on a gift made more than three years before death. Of course, if no gift tax was payable and no other use would have been made of the gift tax exemption used in creating the trust, there is no significant downside in making the taxable gift and causing the trust to be included in the grantor's gross estate. In fact, when the federal estate tax was in effect, there was a potential benefit: an automatic step-up in basis for income-tax purposes to estate tax value because the trust is included in the grantor's gross estate for federal estate-tax purposes.[1]

This year, there is no federal estate tax (although some members of Congress have proposed a retroactive reinstatement of the tax effective as of Jan. 1, 2010). While the estate tax isn't in effect, there is no step-up in basis. Rather, the income tax basis of most inherited assets of someone who dies this year is the lesser of the property's fair market value (FMV) at death or the decedent's basis. In other words, for this year, there is a modified carryover basis regime.

Carryover Basis Adjustments

However, the IRC permits two adjustments to the inherited basis of carryover property. First, under IRC Section 1022(b), the basis of the carryover assets may be increased by $1.3 million (plus certain capital, operating and other losses of the decedent) but not above FMV at death, although, if the decedent was a non-resident alien of the United States, the basis adjustment is limited to $60,000. In addition, under IRC Section 1022(c), an additional $3 million increase in basis is allowed, but again, not above FMV at death, and depending on whether the decedent and/or his spouse is a U.S. citizen or resident, with respect to "qualified spousal property." Qualified spousal property consists of assets inherited directly by a surviving spouse or by a qualified terminable interest property (QTIP) trust.

But the increase in basis may not apply to all assets that would have been in a decedent's gross estate if he had died while the federal estate tax was in effect. As a general rule, only assets both "owned by" and "acquired from" a decedent are eligible for adjustment. IRC Section 1022 clarifies that assets in a revocable trust (with respect to which the election under IRC Section 645 may be made so it's treated as part of the decedent's probate estate for federal income tax purposes), assets in a trust over which the decedent retained the power to control the beneficial enjoyment and assets that pass by reason of a decedent's death without consideration, are eligible for the basis adjustment. These assets are treated as having been acquired from the decedent. In addition, certain joint property is also eligible, as is property received by a decedent within three years of death from his spouse (but not to the extent that his spouse has received

> Avoid being deemed as making a gift under IRC Section 2702 in creating a Medicaid trust from which an individual retains the income for life: "Appoint" the power to control to someone other than the grantor, his estate, his creditors or the creditors of his estate.

the property by gifts from others within that three year period). Property subject to a decedent's general power of appointment, even though such property would be included in a decedent's gross estate for federal estate-tax purposes under IRC Section 2041, isn't eligible for the basis adjustment.

Somewhat surprising, perhaps, is that property in which a decedent retained the right to income for life doesn't appear to be eligible for the basis adjustment because it doesn't appear to be acquired from the decedent. Thus, there may be no basis adjustment when the recipient dies with respect to the assets in the Medicaid trust (even though there would have been a step-up in basis when the decedent died if the federal estate tax were in effect).

If the grantor dies in 2010, there's another benefit to making the gift incomplete—that is, it may permit the trust assets to be eligible for the basis adjustment under the carryover basis rules.

A Cure

There's a relatively simple way for an individual to avoid being deemed as making any gift (much less a larger gift under IRC Section 2702) in creating a Medicaid trust from which an individual retains the income for life. And that way is to retain the power to control where the property passes at death by "appointing" it to someone other than the grantor, his estate, his creditors or the creditors of his estate. That power to appoint, even if it's exercisable only with the consent of another person who is not a beneficiary, will render the gift of all interests in the Medicaid trust incomplete under Treasury Regulations Section 25.2511-2. An incomplete gift, of course, means there's no use made of the lifetime gift tax exemption and no gift tax due. Because the retention of the income interest causes the entire trust to be included in the grantor's gross estate if there's a federal estate tax in effect at death, there's no detriment at all in making the gift to the trust entirely incomplete—and the estate tax inclusion means, when the estate tax is in effect, that the trust assets will receive an income tax step-up in basis.

If the grantor dies in 2010, there's another benefit to avoiding making the gift complete—that is, it may permit the trust assets to be eligible for the basis adjustment under the carryover basis rules. That's because the basis adjustments apply where the grantor has retained the power to control the beneficial enjoyment of the trust assets, which the grantor will have done through the retained power of appointment. And that will be the case even if the grantor may exercise the retained power of appointment only with the consent of someone else who is not a trust beneficiary.

One Hurdle

There's an additional hurdle, however, for the carryover basis adjustments: not only must the property have been acquired from the decedent, but also it must have been owned by the decedent at death. Property in a trust (such as a QTIP trust that the decedent's spouse had created for him) would not apparently be treated as owned by the decedent for carryover basis purposes, even though it would have been included in the decedent's gross estate under IRC Section 2044 if the federal estate tax were in effect. However, in Revenue Ruling 85-13,[2] the Internal Revenue Service takes the position that all assets in a grantor trust[3] are treated for all income tax purposes as owned by the grantor.

A Medicaid trust from which the grantor has retained the right (or merely eligibility) to receive the income and over which the grantor has retained the power to specify how the corpus will pass at death is a grantor trust in its entirety under IRC Sections 677 and 674. Thus, this type of a Medicaid trust should be treated as owned by the grantor at death

because the carryover basis provisions of IRC Section 1022 are income tax provisions, and Rev. Rul. 85-13 applies for all income tax purposes. It also means IRC Section 2511(c) doesn't apply. If the grantor had retained only an income interest (and no control over corpus), the trust likely would be a grantor trust only with respect to income which, in turn, probably means it would not be treated under the revenue ruling as entirely owned by the grantor for income tax purposes and, therefore, would not be eligible for the basis adjustments under the carryover basis rules.

Note that there are other ways in which a trust can be made a grantor trust in its entirety (such as having the grantor retain the power to substitute other assets of equal value for those in the trust).[4] For those of you who like to wear belts and suspenders, this approach might appeal to you. In other words, the grantor retains a limited power of appointment and also the power to substitute property of equivalent value.

Endnotes

1. *See* Internal Revenue Code Section 1014(a).
2. Revenue Ruling 85-13, 1985-1 CB 184.
3. A grantor trust is a trust in which the income, deductions and credits are attributed to the grantor under IRC Section 671.
4. *See* IRC Section 675(4)(C).

SPOT LIGHT

Spring Into Action!
Takashi Murakami's screenprint "Killer Pink," about 21 inches by 54 inches, sold for U.S. $12,071 at Sotheby's "Contemporary Asian Art" auction in Hong Kong on April 5, 2010.