Designing an Income-Only Irrevocable Trust

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## Introduction

The biggest question on the minds of elder law attorneys these days is, do we use Medicaid irrevocable income only trusts as a planning tool or not? It is no secret that across the country these trusts are being challenged by the states more than ever. That being said, recently there have been a series of cases and developments that acknowledge that these type of trusts are an acceptable planning tool to protect assets from the costs of long term care, provided however; that they are carefully drafted so as not to violate the federal or state laws governing these trusts. The balance of this article will explain the important paragraphs to use as well as the paragraphs to avoid when drafting these trusts, along with income, gift, and estate tax “do’s and don’ts” when operating them during the Donor’s life.

## Important Language Your Irrevocable Trust Must Have

Surviving spouse, Mrs. Public, age 75, established an income only irrevocable Medicaid trust in 2007, naming two of her children as trustees. (Note very similar terms would apply for a married couple with the only difference being that income would be payable to both the Donor and the Donor’s spouse). She transfers a $1,000,000 investment portfolio and a $400,000 home into the trust and retained a life estate. She had acquired the home from the passing of her husband six months earlier. The trust provides as follows:

1) For so long as Mrs. Public is alive, income from the trust is payable to Mrs. Public.

2) Under no circumstances is the Trustee permitted to pay to or use principal for Mrs. Public’s benefit.

3) The Trustee, in its discretion, may pay principal to or for the benefit of the class consisting of Mrs. Public’s children of all generations.

4) Mrs. Public reserved, in the trust instrument, the right to appoint principal or income to or for the benefit of charities, other than charities that are also nursing homes or other medical institutions, of her choosing during her life. This is known as a limited power of appointment and is what makes the trust a grantor trust for income tax purposes.

5) Upon Mrs. Public’s death, the property in the trust will be paid over to those persons selected from the class consisting of her issue and or non-governmental charities, in equal or unequal amounts, as designated in a Last Will and Testament referring to this power executed after the execution of the trust. This is known as a testamentary power of appointment.

6) In the event the power is not exercised, the property shall be sold and the proceeds added to the balance of the trust assets and all trust assets to be divided into as many equal shares as there are children then living or children then deceased leaving children then living. In the case of a share allocated to a child such share will be paid out and distributed free of all trusts. In the event a child died then that child’s share would be held in trust for that child’s children rather than that child’s spouse and such share will be held in trust for the benefit of those grandchildren until no such grandchild is under 30 years of age.

**Planning Note:** There are many different ways that one can leave assets to family members and are generally based on your particular family situation. For example, a continuing spendthrift discretionary trust can divorce-proof the trust and provide generation skipping tax benefits. See *Pfannenstiehl* *v.* *Pfannenstiehl*, 475 Mass. 105 (2016).

**Current Status of Problematic Trust Provisions**

1. **Purposes Clauses**: These are paragraphs that indicate that the trust is designed for a reason such as to provide for Donor to have as complete a life as possible and to ensure that the Donor’s assets in the trust are to be used to keep the Donor in the community as long as possible. This type of language could cause the assets in the trust to be countable for Medicaid Purposes. The standard to determine if an asset is countable for Medicaid purposes is if there is “ANY CIRCUMSTANCES”, regardless of how remote, that principal of the trust can be paid to the Donor then it must be paid and will be considered countable. Clauses like this one make it appear that principal is available and thus may result in a denial for Medicaid benefits. While this clause alone may not cause the trust assets to be countable it nevertheless should not be a part of your Medicaid Irrevocable Trust. See *Cohen* *v.* *Comm’s of Div. of Med. Assistance*, 423 Mass. 399, 406–407 (1996); *Doherty* *v.* *Dir. of Office of Medicaid*, 74 Mass. App. Ct. 439, 440 (2009).
2. **Termination Clauses:**  These are clauses placed in the trust that generally allow the trustee under certain circumstances to terminate the trust and distribute the assets out to the beneficiaries. The problems with this type of language is that if all the trust assets can be distributed to the beneficiaries and there is no distinction made between the income and principal beneficiaries and the Donor is generally an income beneficiary, the Court will assume that the principal could be distributed to the Donor of the trust thus making the assets countable for Medicaid purposes. Again if the principal can be paid to the Donor under “*any circumstances*” then it must be paid and will make the assets of the trust countable. See *Doherty*, *supra*.

In a February 6, 2018 Fair Hearing, the state once again challenged a termination clause in a trust. The clause stated if in the trustee’s discretion the trust becomes uneconomic or inadvisable to administer it could be terminated and paid out to the Donor’s issue. The state said termination equaled revocation and since the trust is revocable the assets are countable. The hearing officer disagreed and stated that revocation means the Donor takes an action to get the assets back, but the Donor cannot take such action as the trust is irrevocable. While a termination by appellant/trustee can take place, assets would only go to children and not to the applicant and will not result in the assets going to the Donor but instead to the children. Therefore, the termination clause does not make the assets available for Medicaid eligibility purposes. See Fair Hearing No. 1717924. Best practice is to not have termination clauses in the trust.

1. **Trigger Language:** This language was popular before 1993, but these trusts still exist and were not grandfathered by the 1993 Medicaid legislation. This language generally states that during any period of time that the Donor of the trust is not eligible for Medicaid benefits then the trustee in its discretion can distribute principal to the Donor for his or her care or for health and medical expenses including nursing home care etc. Even though the trust may have stated that the trustee cannot distribute principal to the Donor in any other paragraph, the state will deny you Medicaid benefits because by not being eligible the principal of the trust can be paid out to you. This is certainly language that should not be placed in your Medicaid Irrevocable trust if you want to add certainty to the protection of your assets. More troubling, trusts drafted under prior law that included triggering language were not grandfathered once the updated law was passed. See *Cohen*, *supra*.
2. **Silence as to the Distribution of Principal:** This is when a trust is drafted that states that income can be distributed to the Donor during the Donor’s lifetime but makes no mention as to whether principal can be distributed out to the Donor or not. This is likely to cause the state to take a closer look at the trust and then end up denying Medicaid benefits. There has been a recent fair hearing on this very matter and the state was successful in denying the applicant Medicaid benefits which resulted in the assets in the trust to be countable and at risk for nursing home costs. The state indicated that under the uniform trust code and coupled with the other broad trustee powers that the trust contained that if the trust does not prohibit the trustee from taking an action then that action can be taken. In this case since the trust did not specifically prohibit the distribution of principal then it was determined that principal could be distributed. The prudent form of trust drafting must include a paragraph that specifically prohibits the distribution of principal to the Donor or the Donors spouse under any circumstances. In fact, this may be the single most important paragraph in the trust. See Fair Hearing No. 1222688 (holding fiduciaries given power to distribute principal under broad powers of G.L. c. 190B, § 7-401, and so silence in trust allows distributions of principal).[[1]](#footnote-1)
3. **The Trustees Power to Lend Money to a Beneficiary:** This type of paragraph can usually be found in the trustee power section of the trust. It might generally state that the trustee has the power to lend money to the beneficiary when and if reasonably necessary and with or without interest or security. The real problem with this is that the Donor of the trust is likely an income beneficiary and since the power granted to the trustee allows him to lend money to any beneficiary, the state will determine that there is a circumstance in which principal can be distributed to the Donor therefore the trust assets will be countable and at risk for nursing home costs. It is okay for the trustee to have the power to lend money but just not to the Donor. It would be prudent to make sure your irrevocable income only trust has a paragraph that specifically prohibits the trustee from lending money to the Donor or creator of the trust. See *Edholm* *v.* *Minnesota Dept. of Human Sers.* No. 27-CV-11-23237 (Minn. App. Ct. June 17, 2013, unpublished).
4. **The Right to Redefine Principal as Income in a Reasonable Manner:** The

Uniform Principal and Income Act (“UPIA”) was designed to allow the trustee to allocate Principal from investments to income so as not to limit investing options that may harm the income beneficiaries or vice a versa. This way the trustee would not be forced to invest in only income producing assets to help the income beneficiary while potentially hurting the principal or remainder beneficiaries and again vise a versa. The state has successfully persuaded hearing officers and Superior Court judges that this power permitted a distribution of principal to the Donor. The solution to this problem would be to put in the trustee power section of the trust a paragraph that states, notwithstanding the Massachusetts Uniform Principal and Income Act, the trustee shall have no power to allocate principal to income. Fortunately, this may not be necessary, because of *Heyn* *v.* *Dir. of Office of Medicaid*, 89 Mass. App. Ct. 312 (2016). In *Heyn*, the state argued that the trustee could sell the home in the trust and purchase an immediate annuity then allocate the payment of which are primarily return of principal to income and payout to the Donor/applicant. The Court did not agree and held that the power to allocate between income and principal did not cause the assets to be countable as such exercise is subject reasonable accounting standards and state law. *Id*. at 317–318. See also G.L. c. 203D, § 18(a) (creating presumption that additions to trust default to principal).

1. **The Right to use and Occupy Real Estate:** In many of these trusts the Donor is given the right to use and occupy the home during the Donors’ life. The state has argued that this power makes the home or other real estate “*available*” for the Donor and thus a countable asset and at risk for the costs of nursing home care. However the rules governing these trusts indicate that only trust assets that are payable to the Donor can be countable or at risk for the nursing home costs. The state is challenging this type of language in trusts and so the solution is to simply make sure your trust does not have any such language. In Doherty, the applicant did not retain a life estate but had the right to use and occupy by the house by the terms of the trust, and this was one of the reasons the trust assets—i.e., the house—was countable. *Doherty*, *supra* at 441. In Fair Hearing No. 1200356, the hearing officer agreed with Cushing & Dolan’s argument that the right to reside under the trust terms was akin to a life estate, and such a provision did not make the assets countable. However, the Supreme Court of Massachusetts in the *Daley* and *Nadeau* cases has finally settled this matter once and for all. The Court ruled that the right to use and occupy a house does not give the trustee the ability to sell the house and pay out the principal and thus does not make the house payable to the Donor and is not a countable asset for Medicaid eligibility. The Court considered it a payment of income akin to rent and not a payment of principal. *Daley v. Secretary of the Exec. Office of Health and Human Sers*., 477 Mass. 188 (2017).
2. **The Right of Substitution:** This is generally a power that is put in that allows the Donor the right to withdraw all of the trust assets as long as they are replaced with assets of the same value. This is a power that is used to make the trust a grantor trust for income tax purposes. See I.R.C. § 675(4)(C). This is what would allow all of the trust income and capital gains to be reported on the Donor’s personal income tax return so that he continues to pay the income tax at his lower rates just like before the trust was established. However, the state will interpret this to mean that the assets of the trust can be paid out to the Donor thus considered a countable asset. The solution to this problem is to simply not use this power in your trust document. You can accomplish the same favorable income tax benefits by using a limited power of appointment, which allows the Donor to appoint the income and principal to charities during his life, as mentioned above. However, the *Heyn* case mentioned above also indicated that this removal and replacement language would not make the assets in the trust countable for a Medicaid eligibility determination. The Court stated it would be no different than if a house were sold and replaced with money of equal value, the money would be no more countable than the house would be based on the terms of the trust. See *Heyn*, *supra* at 319 (right of substitution does not cause trust assets to be countable). However, a recent September 15, 2017 MassHealth fair hearing has taken a new position on the use of this power to remove and replace trust assets with something of equal value. The hearing officer agreed with the state’s argument that the Donor could transfer assets out to himself and put back into the trust a promissory note of equal value. The trust would receive the payouts and the Donor applicant would have use of the assets and therefore countable for Medicaid eligibility purposes. Since the trust would only be receiving payments back that would not violate any of the trustee duties not to pay principal to the Donor. See Fair Hearing No. 1614961. Query if the attorney argued that the assets the applicant received from the trust was not an asset at all but a liability if the result would have been different. Best practice remains not to use this power in the trusts.
3. **The Right to Pay the Donor’s Estate tax, Estate Administration Costs, and Costs Associated with Last Illness:** In these cases the trustee granted the right to pay for any estate taxes due following the Donor’s death or all costs associated with his last illness and/or as needed to close out the estate. The problem with this Power is that these expenses are generally large and would likely cause the trustee to be using principal of the trust for the benefit of the Donor. Any time principal can be used for the benefit of the Donor makes the trust assets countable. Furthermore, there are cases that state the cost of the nursing home was a cost associated with the Donor’s last illness. This allows the state’s estate recovery unit to force the access of trust principal to pay the bill. Thus, even if qualified for Medicaid benefits, the trust assets would be at risk for estate recovery purpose. This type of paragraph should not be a part of your trust. See *In re Estate of Melby*, 841 N.W.2d 867 (Iowa 2014) (trust assets countable because of ability to pay expenses of Donor).
4. **Compensation of Trustees:** In cases where the Donor of the trust is also the trustee, MassHealth may argue that the power of the trustee to compensate himself permits the distribution of principal to the Donor. Of course, this ignores the fiduciary principles of a trustee, as recounted in *Heyn* and *Doherty*, but nevertheless, best practice is to appoint a person other than the Donor as trustee and have language that allows the removal and replacement of the trustee but state that the Donor can never serve as trustee. See *Leger* *v.* *Comm’s of Div. of Med. Assistance* Middlesex Sup. Ct. Civil No. 96-0768 (Sept. 3, 1998) (describing practice of Donor appointing self as trustee as unappetizing maneuver). There have been several fair hearing decisions, in 2016-2017, that have stated that trustee compensation does not make the entire principal of the trust payable to the Donor. However, hearing officers have eluded to the fact that if the state could show what amount of compensation was reasonable that amount of assets could be considered available in a Medicaid eligibility determination. See Fair Hearing No. 1702593. The state has made this very argument in a recent fair hearing by arguing that a reasonable trustee fee would be approximately $4,000/year, the decision of which has not been issued as we go to print. However, this trust had around $600,000 in investable assets and I showed prior income tax returns demonstrating there would always be enough income to pay the trustee fee so that principal would never be so used or available. The only way it would not have enough income would be to put all the money into a non-interest bearing checking account, which would in turn violate the trustee’s fiduciary duty and the prudent investor rule which is not permitted.
5. **Limited Powers of Appointment:** Donors may reserve a limited power of appointment to the Donor to appoint under the trust. MassHealth has argued that this limited power causes the assets to be countable, as the Donor could appoint the assets to the beneficiary, who in turn could return the assets to the Donor. Massachusetts and New Hampshire have expanded their attacks to suggest that since the power to appoint allows conditions to be attached to the appointment that such a distribution can be conditioned on it or some portion of it being returned to the Donor. The states have also suggested that a Donor can threaten disinheritance through the exercise of a testamentary limited power of appointment if such distributed assets to the child are not returned to the Donor/parent or be used to pay for their care. Thankfully, Massachusetts Appeals Court in *Heyn* rejected the analysis, as the assets of family members (other than the spouse) are not considered when making eligibility determinations. See *Heyn*, *supra* at 318–319. In fact, the *Heyn* Court found that “a provision making trust principal available to persons other than the grantor does not by its nature make it available to the grantor, any more than if the grantor had gifted the same property to such person when she created the trust, rather than placing it in trust.” Further, the Court noted that “for purposes of computing countable assets, Medicaid does not consider assets held by other family members who might by reason of love but without legal obligation, voluntarily contribute monies toward the grantor’s support”. *See Heyn, supra at 318-319).*

Further, the *Heyn* decision was applied in a February 6, 2018 Fair Hearing decision in which Massachusetts again argued that a distribution to a child from the trust could be made via a limited power of appointment with the attached threat of disinheritance if such assets were not returned to the Donor or used for his care. The hearing officer said the *Heyn* rational must apply here and that MassHealth should not consider as countable, assets held by other family members who might by reason of such threatened disinheritance, contribute monies toward appellants support. See Fair Hearing No. 1717924. Finally, the U.S. District Court, ND NY threatened disinheritance in *Verdow* *v.**Sutkowsky*, 209 F.R.D. 309 (N.D. N.Y., 2002) also dealt with this issue and held that absent of bad faith or fraud the decision of whether or not to provide Medicaid benefits should not be based on the remote possibility of collusion.” 209 FRD 309 (N.D. N.Y. 2002). See also two New Hampshire Hearings dealing with same issue. See New Hampshire Fair Hearing Docket No. 2016-846 and New Hampshire Fair Hearing Docket No. 2017-378.

1. **Pooled Trusts as Charities:** MassHealth sometimes argues that the power to appoint to a charity runs afoul of the any circumstances test. Per MassHealth’ s argument, such a provision allows the Donor to appoint to a pooled trust, which is a type of trust managed by a nonprofit organization that allows for certain payments back to the Donor of the pooled trust. After the Donor’s death, the pooled trust must pay back the state, then between 10% and 20% goes to the sponsoring charity, and finally the balance is distributed to the family. This argument fails, because the pooled trust itself is not a charity, and the trust does not permit appointment to a non-charitable entity. There have been several, 2016 and 2017 MassHealth fair hearings in which the officer has concluded that a pooled trust is not a charity and such an appointment cannot happen under this limited power of appointment as such exercise would violate the very definition of the limited power and thus the assets in those trusts were non-countable for Medicaid eligibility. See most recent Fair Hearing No. 1702593. Recently the Massachusetts Supreme Court in the *Daley* and *Nadeau* decision remanded back to the hearing officer to consider the idea that assets that can be appointed to a nursing home that is a charity or non-profit, may be for the benefit of the Donor/applicant if the Donor is also residing in that nursing home. Since then the Board of Hearings has reconsidered this idea on remand and has concluded that the limited power of appointment could not be exercised in that manner and would not cause the assets to be countable. See Fair Hearing No. 1408634 remand. Additionally, there is a January 29, 2018 Mass Superior Court case, *Sheryl Keddy* *v.* *MaryLou Sudders* addressed and resolved this very issue. The Court said that MassHealth’s reliance on *Daley* regarding this issue is misplaced. The Court noted that the trust states that the limited power of appointment explicitly prohibits distributions to the applicant, her estate, her creditors, or creditors of her estate (i.e. a nursing home). Therefore, there would be no way or no circumstance in which the Donor or applicant could have used trust assets to pay the nursing home. See *Sheryl Keddy* *v.* *MaryLou Sudders*, Superior Court Civil Action No. WOCV2016-01500; See *Heyn, supra* at 318-319*.*
2. **Use of Principal to Make Capital Improvements**: In a recent fair hearing dated September 15, 2017, the trust had language that allowed the Donor the right to use and occupy. It also allowed the trustee to pay principal to make capital improvements on the home. The hearing officer agreed that the right to use and occupy would not cause the home to be countable following the Daley Nadeau decision. However, since principal can be used to make capital improvements on a home that the Donor was residing in, then that would mean principal can be used to benefit the Donor and thus makes it countable for Medicaid eligibility determination. See Fair Hearing No. 1614961. Best practice is to not put such language in your trust. However, this author believes this case should have been appealed. The *Daley* Court states that if the home cannot be sold and principal paid out then the home and all its equity, arguably regardless of how many improvements were made to it, should not be a countable asset for Medicaid eligibility purposes.
3. **Deposit in a Continuing Care Retirement Community (“CCRC”) – Is it a Countable Asset:**  A recent fair hearing dated January 31, 2018 involved a married couple who entered a CCRC and made a deposit of $225,000 to the facility. Later, the husband moved to the nursing home wing while the spouse continued to reside in the independent living wing. The application was initially denied because the state argued that the $225,000 deposit was a countable asset. It turns out that there is no Massachusetts regulation on point but a federal regulation exists. 42 U.S.C. §1396 (g)(1)(2). The hearing officer concluded 42. U.S.C. § 1396 (2)(B) is not satisfied. The only way the applicant could get the deposit would be if he and his community spouse were to die or leave the facility. The language of the contract is clear that if one spouse dies, one spouse continues to reside in the CCRC then the deposit is deemed to have been paid entirely on behalf of the survivor and to be used for the survivor’s care. Again, demonstrating the only way to get the refund would be for the applicant to transfer out to a different facility and the community spouse to move out as well. Therefore, this would be an unattainable situation and thus the deposit is not countable for Medicaid eligibility purposes. See Fair Hearing No. 1718268.
4. **Valuation Limitations and the Caretaker Child Exception:** In a Fair Hearing dated September 1, 2017, the hearing officer had to address the issue of the value of a home transferring to a caretaker child. In this case there was no question that the child had lived with and cared for the parent/applicant for two years prior to her admission to the nursing home in accordance with 130 CMR 520.019(D)(6). The issue was the application of the home valuation limitation of $840,000 pursuant to 130 CMR 520.007(G)(3). This regulation indicates that if the home equity value exceeds $840,000 and no community spouse or disabled child is living there, then the individual is eligible for benefits. The home in this case was worth $951,700. The hearing officer ruled that the regulation 130 CMR 520.019(D)(6) allowing the transfer of a home to a caretaker child does not have any value limitation applied and MassHealth cannot place such limits that are not set forth in the regulations. Therefore, this transfer was permissible and benefits were approved. See Fair Hearing No. 1706269.
5. **Right to Potential Future Income:** In a Fair Hearing dated February 6, 2018, the hearing officer had to address the issue of future potential income as a trust asset. The state argued that a home in a trust that allowed the applicant the right to live there should be generating rent. Mass Regulation 130 CMR 520.023(c)(1)(a) states that income from principal or income on corpus is to be treated as a countable asset or resource of an individual. Therefore, the value of all the rent over the life expectancy of the applicant should be imputed and treated as an asset. The hearing officer agreed that actual accumulated income would be an asset and must be paid out. This interpretation is consistent with 42 U.S.C. §1382b(e)(6)(B) which states, the term “corpus” means, with respect to a trust, all property and other interests held by the trust, including accumulated earnings and any other addition to the trust after its establishment (except that such term does not include any such earnings or addition in the month in which the earnings or addition is credited or otherwise transferred to the trust). This section also supports the conclusion that since any such trust earnings are not considered earnings of the trust in the month earned but are in the following months, that future assets or corpus of the trust cannot be considered an asset or corpus for MassHealth eligibility purposes. See Fair Hearing No. 1717924.

**How Do These Irrevocable Income Only Trusts Operate and What Can You Do and Most Importantly What Can You No Longer Do After These Trusts Are Created and Implemented**

**Question: Who would consider using these Medicaid irrevocable trusts?**

**Answer:** While there is no hard and fast rule as to who can use these trusts, it is generally recommended to folks who have attained 60 years of age or older. In addition, you should consider using these irrevocable trusts if in fact one of your objectives in the estate and elder law planning world is to protect assets from the cost of long term care. In the event this type of asset protection planning is not important to you, then a revocable trust would be the recommended vehicle for your estate planning needs. Finally, if you happen to be under age 60 but have a diagnosed mobility related illness, then of course you could consider the use of these irrevocable trusts as well.

**Question: Who can be the Donor of these irrevocable trusts and what does that mean?**

**Answer:** The Donor is referred to as the individual who creates the trust. The Donor may also retain certain powers over the trust, most importantly, the power to remove and replace a trustee at any time for any reason, provided, however, that the replacement trustee can never be the Donor of the trust. This retained power by the Donor allows the Donor to retain a significant degree of control over the operation of the trust, even though the Donor does not serve as trustee. In addition, the Donor will also be an income beneficiary of the trust.

**Question: Who can be the trustee of these irrevocable trusts?**

**Answer:** Often times, the Donor would like to serve as trustee of the trust thereby significantly increasing the Donor’s control over the operation of the trust assets during the Donor’s life. There is support for this position in Massachusetts where there is a case entitled *Ledger v.* *Department of Medical Assistance* in which the Court indicated that, while this may appear to be an unappetizing maneuver, it nonetheless fails to contravene any rule or regulation. However, there has since been another case known as the *Doherty* case in which the Appellate Court in Massachusetts indicated that the irrevocable trust was not drafted properly and provided too much control to the Donor, whereby causing the assets of the trust to be at risk. Therefore, it is the recommendation that the Donor not serve as trustee and that the trust itself prohibits the Donor from serving as trustee.

**Question: Do these trusts avoid the costs associated with the probate process?**

**Answer:** An individual who passes away and owned assets in their own name, without a designated beneficiary, will subject all of those assets to the costs associated with the probate process. By establishing this irrevocable trust and, most importantly funding the trust with assets, will enable the assets that have been retitled to the name of the irrevocable trust to avoid the costs associated with the probate process. Always remember that if you just have a will this is the one document that must be filed with the Probate Court so if this is all the planning that you have done there is a good chance that you may not have even avoided probate. Finally, a will by itself will not help you reduce your estate tax liability, or protect assets from the cost of long-term care.

**Question: Do these irrevocable trusts protect assets from the costs of long-term care and how long does it take?**

**Answer:** Once assets have been transferred to these properly drafted Medicaid irrevocable trusts, the assets will be protected from the costs of long term care after the expiration of five years from the date of transfer. This is known as a five year lookback period for Medicaid eligibility purposes. This means that, from the date in which you would apply for Medicaid benefits, the state is entitled to look back at all of your prior transactions, bank accounts, investment accounts, etc., for the previous five years in order to see if there were any disqualifying transfers made during that period which would in fact prevent you from being eligible for Medicaid benefits. A disqualifying transfer is when a formerly available asset is transferred for less than fair market value to a place where it is no longer available for the nursing home. This same five year waiting period applies even if the assets are just given to children and not to a trust. Once you have successfully made it beyond five years from the date of transfer to the trust, the state would then no longer be able to see such a transfer and therefore it would be protected from the costs of long term care.

**Planning Note House Bill 6300:** Just a reminder, this five year look back period is under review and the federal government is constantly exploring the idea of expanding it to be a 10 year look back period.

**Question: How is the transfer penalty (or “period of ineligibility”) computed?**

**Answer:** To determine the penalty (or “period of ineligibility”), the value of the gift (in this case $1,233,964) is divided by the average daily cost of private nursing home coverage (also known as the adjustment divisor) on the date of application. 130 CMR 520.019(G)(1). For applications currently filed, the adjustment daily divisor is $354 (or $10,620 per month). In this case, the penalty would be 116.19 months ($1,233,964 x $10,620).

**Planning Note:** Valuation of the remainder interest is accomplished by 130 CMR 520-019(I)(1). We compute the value of the remainder interest in the property for MassHealth purposes by multiplying the tax assessed value at the time of transfer, $300,000 by the remainder interest of .77988, to get a total transfer of $233,964. See below for calculation. By adding the value of the 1 million in cash and securities transferred into the trust at the same time, a total transfer of $1,233,964 took place on the creation of the trust. If no retained life estate, then just use the real estate tax bill value for penalty period calculation purposes.

**Question: When does the penalty begin to run?**

**Answer:** For transfers occurring prior to February 8, 2006, the penalty begins to run on the date of the transfer. 130 CMR 520.019(G)(3). In this case, notwithstanding the fact that the penalty period of 9.68 years has not yet run, this transfer would be fully protected under the 5 year lookback rules applicable to transfers into trust.

**Planning Note:** For transfers occurring on or after February 8, 2006, the penalty does not begin to run until the later of when the applicant is institutionalized and otherwise eligible. This basically means that the penalty doesn’t begin to run until after the donor is institutionalized and has less than $2,000. Therefore, YOU MUST WAIT 5 YEARS TO PROTECT ANY TRANSFERS.

**Question: Which type of assets should a person retitle or transfer into one of these irrevocable Medicaid trusts?**

**Answer:** First and foremost, IRA assets or any other qualified plan asset or retirement type asset, such as a 401(k) plan or a 403(b), should not and, in fact, cannot be transferred into these irrevocable trusts during life. In order to transfer one of these qualified plan assets into the trust, you would first need to withdraw the money from the qualified plan, thereby subjecting it to ordinary income tax liability and transferring only the amount net of taxes to the trust. Generally, this makes funding an irrevocable trust with such assets cost prohibitive.

The qualified plan type assets should now be used to live on during your life since the retirement plan assets would be outside the trust and therefore at risk for the costs associated with long term care.

A common asset that folks like to transfer to the trust would be their primary residence. It is also possible to transfer rental property or vacation property to these irrevocable trusts in order to protect them from the costs of long term care.

Finally, people also wish to transfer their non-qualified investment portfolios or a portion of their investment portfolios to these irrevocable trusts in order to protect them from the costs of long term care. All of those types of assets can, in fact, be transferred to the irrevocable trust without any adverse income or gift tax consequences.

**Question: Is there a gift tax liability associated with transferring the investment portfolio and the home into these Medicaid irrevocable trusts and does a gift tax return need to be filed?**

**Answer:** There are no gift tax liabilities associated with transferring assets to these irrevocable trusts because the gifts to these are trusts are known as incomplete gifts for gift tax purposes since the Donor retains the right to designate the final beneficiaries of the trust in accordance with Treasury Reg. § 25.2511-2C. See also I.R.C. § 2511. In addition, no gift tax returns are required to be filed to report the transfer to the trusts, except if you wish to disclose the transfer to commence the running of a statute of limitations for auditing the gift. Treas. Reg. § 25.6019-3(g).

A gift tax return should probably be filed, if only to provide full disclosure. If the Donor retained a provision in the trust rendering the gift incomplete, the regulations provide that a gift tax return should be disclosed on a return, but a failure to file would not render the taxpayer subject to any penalties or gift tax. In most cases, no gift tax return would have been filed. The risk is that the transfer was not incomplete and gift tax would have been due giving rise to penalties. Under Treas. Reg. § 25.6019-3(a), “[i]f a Donor contends that his retained power over property renders the gift incomplete and hence not subject to the tax as of the calendar quarter or calendar year of the initial transfer, the transaction should be disclosed in the return for the calendar quarter or calendar year of the initial transfer and evidence showing all relevant facts, including the copy of the instrument of transfer, shall be submitted with the return.

**Planning Note:** If the Deed transferred the real estate to a child and the Donor, Mrs. Public, reserved a life estate, there would have been a completed gift, which would need to be reported since the grantor did not reserve the right to designate the final beneficiaries. In addition, if the $1,000,000 in cash and marketable securities had been transferred to a child, a gift tax return would have been needed since the total gifts would have exceeded the $15,000 present interest exclusion even though not in excess of the gift tax exemption for 2007.

**Question: How do you compute the amount of the gift for gift tax purposes if the transfer of the real estate had been to a child rather than to a trust?**

**Answer:** Assume the 7520 rate applicable for the date of the transfer was 2.4%. Using Table S, single life factors based on Life Table 90CM with interest at 2.4%, the life estate portion is worth .22012 and the remainder interest is worth .77988. Therefore, to compute the value of the gift, you would multiply the fair market value of the property of $400,000 by .77988 ($311,952).

**Question: What is the value of the transfer of the real estate for MassHealth purposes?**

**Answer:** Pursuant to MassHealth Eligibility Operations Memo 07-18, the same rate would be applicable by referring you to Table S. The difference, however, would be to use the assessed value rather than fair market value pursuant to MassHealth Regulation 103 CMR 520.007(G)(3)(a). The value of the transfer for MassHealth purposes will be $300,000 multiplied by .77988 ($233,964).

**Question: What is Mrs. Public’s basis in the property assuming the property was purchased for $40,000 in 1970?**

**Answer:** $400,000 as a result of IRC § 2040(b) and *Gallenstein v. United States*, 92-2 USTC, P60,114 (Ed. KY 1991), aff’d 975 F.2d 286 (6th Cir. 1992). See, also *Patten*, 97-2 USTC, P60,279 (DC CA 1996), and *Anderson*, 96-2 USTC P60,235 (DC MD 1996). This Code Section and these cases stand for the proposition that, as to property acquired by a husband and wife prior to 1977, 100% of the property would be includible in the estate of the first spouse to die. There will be no estate tax because of the unlimited marital deduction, and the surviving spouse would have a full step-up in basis in the property.

**Planning Note:** If the property had been acquired after 1976, the surviving spouse would have a basis equal to $220,000, determined by adding one-half of the purchase price ($20,000), and one- half of the value on the date of death ($200,000).

**Planning Note:** It has been suggested that, notwithstanding this well-established rule, if the spouse who dies first did not contribute to the purchase price because the deceased spouse was a home maker, for example, then the surviving spouse would receive no step up in basis (and not even one-half). This does not seem to be supported by the Regulations. Regulations 20.2040-1, joint interests, (a)(2) provides: “The entire value of jointly held property is included in a decedent’s gross estate unless the executor submits the facts sufficient to show that property was not acquired entirely with consideration furnished by the decedent…” This provision suggests that an election is available to the executor rather than any mandatory rule. There is no case directly on point.

**Question: What is Mrs. Public’s basis in the property for Massachusetts income tax purposes if different from the federal basis?**

**Answer:** This depends upon when the first spouse died. The governing case is *Treat v. Commissioner*, 52 Mass.App.Ct. 208, 201. The Treat case involved a spouse who died in 1993, several years before Massachusetts completed the repeal of its estate tax system. Dealing with a 1993 death, the Appeals Court relied on General Laws Chapter 65C, §1(d), which is applicable to deaths occurring before January 1, 1997. This section provides:

“The federal gross estate’, the gross estate as defined under the Code except that, (1) notwithstanding Section 2035 of the Code, the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has, at any time made a transfer, relinquished the power or exercised a released a power of appointment, except in case of a bona fide sale for adequate and full consideration in money or money’s worth, by trust or otherwise, during the three year period ending with the date of the decedent’s death, provided however, the value of such property or interest therein so transferred or subject to the power so relinquished, exercised, or released, exceeds $10,000 for any person during the calendar year; and (2) notwithstanding Section 2040 of the Code, one-half of the value of any interest in any property shall be included in the gross estate of such interest is held by the decedent and the decedent’s spouse as tenants by the entirety or joint tenants with rights of survivorship, but only if the decedent and the spouse of the decedent are the only joint tenants.”

This section does not apply to decedents who died on or after January 1, 1997. Under current law, the Massachusetts estate tax, and by implication the definition of gross estate is based upon the federal estate tax credit pursuant to IRC § 2011. As a result, the surviving spouse should acquire a full step-up in basis for Massachusetts income tax purposes, provided the decedent died on or after January 1, 1997. Therefore, in this case, since the decedent died after January 1, 1997 a full step up in basis will apply in Massachusetts as well.

**Question: What would the basis in the hands of the children be if she had transferred the real estate to her children and not retained a life interest in the property, but continued to occupy the property as though she owned it and** **paid all expenses until her death? None of the children reported any income attributable to rent.**

**Answer:** In such a case, the decedent would have acquired a step-up in basis equal to the fair market value of the property on the date of death.

In the *Estate of Guynn*, 437 F.2d 1148 (4th Cir. 1971), the Circuit Court of Appeals ruled that where the donor and the donee are other than a husband and wife, such as a transfer of a home from a single parent to a child, then the IRS could successfully assert an argument that there was an implied life estate under IRC § 2036. See also, Rev. Rul. 70-155, 179-1CB 189.

Also, in *Estate of Maxwell*, 98 T.C. 39 (1992), the Tax Court ruled that the value of a decedent’s former home should be included in the decedent’s estate, even though the decedent “sold” the property to a child for $270,000, required payments of interest only at 9% per year (no principal was required), the decedent’s Will forgave the Note at death, and the decedent cancelled $20,000 in a Note each year. The problem was that the decedent did not move out of the house and the Court found that an implied agreement to use and occupy the home existed under IRC § 2036(a).

On the other hand, in the *Estate of Powell v. Commissioner*, 63 T.C.M. 3192 (1992), the decedent transferred approximately 60% of his ownership interest in his principal residence to his children and their relatives. The decedent died owning 40%. The decedent continued to live in the home until he was forced to move because of his physical condition. The decedent paid all expenses, including real estate taxes, maintenance, and upkeep. The IRS unsuccessfully argued that the decedent retained a life estate under IRC § 2036. The Tax Court disagreed with the IRS’s arguments finding that his continued occupation of the residence was consistent with his ownership interest as a tenant in common with his children. See, also *Estate of Wineman*, 79 T.C.M. 2189 (2000), 24% of the property gifted more than 20 years before death held not includible.

**Question: Who is responsible for paying expenses attributable to the property after the property is transferred to the trust subject to a life estate?**

**Answer:** The life tenant is responsible for paying all expenses associated with ownership, with the exception of capital improvements. This means that the life tenant would be paying property taxes and will be entitled to an income tax deduction with respect to such payments. If the property was rental income, then the rental income would simply be reported by the life tenant on Mrs. Public’s Form 1040. A remainderman owes no duty of care to the life tenants, absent a duty voluntarily assumed by the remainderman. *Delprete v. Ferrante*, et al, L.W. No. 16-106, Judge King, Suffolk County No. 90-2152B.

**Question: Can I continue to live in my home after it has been transferred to one of these Medicaid irrevocable trusts?**

**Answer:** Yes, and you do not need any special language in the trust stating that you are permitted to live there the rest of your life or to use and occupy the property. To ensure you have this right you may consider retaining a legal life estate in the deed transferring the property to the trust. See *Heyn* *v.* *Dir. of Office of Medicaid*, 89 Mass. App. Ct. 312, 313 n.3 (2016), and the *Daley* case both discussed above. This will give you the right to live there, among other things, for the rest of your life. If the trustee tried to sell the home, he would now need your signature. Plus, you as Donor retain the right to remove the trustee.

**Question: Can the home be sold after it has been transferred to one of these Medicaid irrevocable trusts? How does it work?**

**Answer:** Yes, you can sell the home after it has been transferred to the irrevocable trust. The trustee of the irrevocable trust would sign the purchase and sale agreement in order to complete the transaction. Selling the property from the irrevocable trust in no way complicates the transaction nor adversely impacts the buyer. Upon completion of the transaction, the buyer would cut a check made payable to the trustee of the irrevocable trust who then would in turn deposit the check into a bank account that is established in the name of the irrevocable trust. It is important to insure that the Donor does not receive the money personally, but instead the money is transferred directly into the irrevocable trust bank account so as not to restart the five year waiting period. Finally, the house can be sold any time after it is transferred to the trust, even if it is during the initial five year period from the date of transfer.

**Question: Does the sale of a home from the irrevocable trust re-set the Medicaid five-year lookback period?**

**Answer:** The five year lookback period is unaffected and, in fact, not reset by the selling of a home from the irrevocable trust, since nothing new was placed into the trust. The five year lookback period starts to run on the day an asset was transferred from an individual’s own name into the irrevocable trust and not the day the trust sells the property.

For example, if the Donor establishes an irrevocable trust and transfers the property into the trust on January 1, 2015, and then, on January 1, 2018, the trustee of the trust sells the property and in exchange the trust receives the proceeds, which are promptly deposited into the irrevocable trust bank account, that transaction will have no impact on the initial five year waiting period that began on January 1, 2015, when the home was transferred to the irrevocable trust.

In other words, the proceeds from the sale of the home, which are now deposited in the trust, will be protected from the cost of long term care in two more years, which represents the balance of the number of years remaining from the initial transfer of the home to the trust on January 1, 2015. Again, since nothing new was placed into the trust, there is no new five year waiting period created. In this case, the trustee simply reinvested the assets that were already inside the trust from real estate to cash or any other investment of the Donor’s choosing.

**Question: Can the trustee of the trust use the proceeds from the sale of a home to purchase a new home inside the trust?**

**Answer:** Once the irrevocable trust receives the proceeds from the sale of the home and are deposited into the trust bank account, the trustee may invest those assets in any manner the trustee deems fit. In other words, the trustee may simply write a check to the seller of a home that you are interested in purchasing and the seller will prepare a deed transferring the property to the trustee of the irrevocable trust. Once again, this transaction of purchasing the home inside the irrevocable trust does not reset the five year waiting period.

As a practical matter, when one spouse passes away, it is not uncommon for a surviving spouse to downsize and sell the old primary residence and convert it to a condominium or some other downsized home. This transaction is completely permissible within the terms of the trust and again would not reset the five year waiting period for Medicaid eligibility purposes.

**Question: Assuming the property was sold on November 1, 2017 for $600,000, what are the income tax and MassHealth consequences?**

**Answer:** Income Tax Consequences – In order to sell the property, Mrs. Public, as well as the trustees of the trust, would need to sign the deed. Since the life estate is a property interest, a portion of the proceeds would need to be paid directly to Mrs. Public and a portion would need to be paid directly to the irrevocable trust. The amount to be paid to each party is determined based upon the Table S using the 7520 rate in effect on the month of the sale. Basis in the property is similarly allocated.

Cash and the gain are allocated based upon these percentages. That portion of the sale proceeds allocated to the life tenant will be eligible for the capital gain tax exclusion under IRC § 121. As a single person who owned and occupied the residence as her home for two out of the last five years, she would be able to exclude up to $250,000 in capital gain. The balance will be taxable at 15% and 5% (Massachusetts). Revenue Ruling 71-122. The portion of the proceeds allocated to the trust may or may not be taxable depending upon whether the trust is a grantor trust. If the property had been deeded to the child instead of the trust, the portion of the proceeds allocated to the child would be taxable as capital gain with no exclusion since the child did not live in and own the home for two of the last five years.

If the trust is a grantor trust, the trust must file Form 1041, identify itself as a grantor trust, and send a tax letter to the grantor informing the grantor that the grantor is responsible for reporting the trust’s portion of the gain. In this case, the total gain is $200,000 ($600,000 - $400,000). Assuming the same 7520 rate of 2.4%, the life estate portion is 14.8%, which means $29,600 would be included, but the remaining $170,400 would be reported by the remaindermen. If the remaindermen are the children, it would be fully taxable at capital gain rates. If the remainder portion was owned by a grantor trust, then that gain would be reallocated to the grantor and eligible for the capital gain tax exclusion making the full $200,000 income tax free. Rev. Rul. 66-159 and Rev. Rul. 85-45.

As a result of the sale, a 1099-S will be issued to either Mrs. Public or her irrevocable trust, or both depending upon whether or not Mrs. Public directs the closing agent to issue separate 1099s (one to Mrs. Public and one to Mrs. Public’s Irrevocable Trust) in order to reflect the appropriate percentage of the gross proceeds allocated to her (as the holder of the life estate) and to her trust (as the remainderman).

MassHealth Consequences: Sale of a life interest is governed by 130 CMR 520-019(I)(2). “If the nursing facility resident’s . . . life estate interest or property including the life estate interest is sold or transferred, the value of the life estate interest at the time of the sale (emphasis added) or transfer is calculated in accordance with the Life Estate Tables as determined by the MassHealth agency. The MassHealth agency will attribute the value of the life estate interest at the time of the sale or transfer to the person selling or transferring the life estate.”

The portion of the sale proceeds allocated to the life tenant becomes a countable asset, which is once again determined by looking to the applicable 7520 rate in effect on the month of sale and Table S. If the grantor is in a nursing home, to the extent the life tenants share of the proceeds together with other assets exceed $2,000, the applicant would be disqualified from MassHealth benefits unless further action is taken, such as an annuity or an additional gift.

**Planning Note:** This is probably the biggest disadvantage to retaining a life estate. In this case, assuming a life interest of 14.8%, $88,800 would be allocated to the grantor disqualifying the grantor from receiving benefits. If instead of reserving a life estate the property had been transferred by fee simple interest into the trust, no portion of the sale proceeds would need to be reallocated to the grantor and the entire sale proceeds would be protected from MassHealth and the taxpayer would not have to pay any capital gain because the gain, even though realized by the trust, would be reallocated to the grantor for income tax purposes and it would be eligible for the capital gain tax exclusion under IRC § 121.

**Question: Can I transfer rental property into one of these Medicaid irrevocable trusts and, if so, what are the tax and operating implications?**

**Answer:** Rental property can be transferred to these irrevocable trusts and there would be no adverse tax implications of doing so. Remember, like the primary residence, this rental property can be sold and the proceeds can in fact be used to purchase another piece of property at any time during or after the five year lookback period. There would also be no adverse income tax consequences associated with any such sale. In other words, you would continue to pay all of the same capital gains taxes associated with the sale of rental property out of the trust as you would if you had sold the property from your own name.

**Question: After rental property has been transferred to a Medicaid irrevocable trust, how is the rental income generated handled and who receives it?**

**Answer:** These Medicaid irrevocable trusts are designed as income only grantor trusts, which mean that the trustee is obligated to pay out the income earned by the trust to the Donor and remember rent is income. In this regard, the tenant would write a check for the rent and make it payable to the trustee of the irrevocable trust. The trustee of the irrevocable trust must have established a checking account in the name of the irrevocable trust under its own tax identification number in order to deposit this rent check into the trust checking account. The rent check represents trust rental income in which the trustee is then obligated to write a check out of the trust checking account payable to the Donor of the trust, who in turn will deposit that check into his or her own personal checking account. You can also set the trust account up in a way that will automatically transfer the rental deposits to the Donor’s personal checking account to be used as desired, which means the trustee does not need to be involved in these transactions.

In other words, the rental income will end up in the Donor’s personal checking account through this two-step approach instead of directly, which is where the rental income use to go prior to the rental property being transferred to the irrevocable trust. The Donor is then free to spend that rental income on anything he or she desires, just like before the establishment of the trust.

From a liability perspective, it may be advantageous to transfer rental properties into LLCs. In the event that a tenant or guest is injured in the rental properties, the existence of the LLC will help protect your personal assets from being taken in satisfaction of a legal judgment against you.

**Question: Do these Medicaid irrevocable trusts have to file separate income tax returns and, if so, does that result in an increased income tax liability?**

**Answer:** These trusts are considered grantor trusts and should file an income tax return, but all the elements of income, deductions, credits, and the like should also be reported on the grantor’s return. I.R.C. § 674(a) causes the trust to be a grantor trust if the Donor retains the power to appoint principal and income during his life. In this trust, Mrs. Public can appoint both to charities so it is a grantor trust. It is also important that the trust obtain a separate tax identification number for this purpose. However, since the trust is a wholly owned grantor trust for income tax purposes, as described above, the trust will effectively not pay any separate federal income taxes. Instead, this grantor trust status causes the Donor to be treated as the owner for income tax purposes and essentially flows the income through the trust and causes it to be reported on the individual Donor’s income tax return, Form 1040, just like it used to be done prior to the establishment of this irrevocable trust. Therefore, these Medicaid irrevocable trusts are known to be income tax neutral, resulting in no increase or decrease in income tax liability to the Donor. The Donor will continue to pay the same tax as he or she did prior to the establishment of the irrevocable trust.

**Question: If Mrs. Public did not sell and instead died owning it in the trust, would the trust assets receive a step-up in basis for capital gains tax purposes upon the death of the Donor?**

**Answer:** Since the Door retained the right to the income under I.R.C. § 2036(a), the trust assets will be included in the Donor’s estate and will get a full step up in basis upon the death of the donor. This step-up in basis rule can be important in reducing future capital gains tax liability associated with the sale of the property following the death of the Donor. A step-up in basis means that the cost basis in the hands of the beneficiaries following the death of the Donor would be equal to the fair market value of the asset received as of the date of the Donor’s death. Therefore, if the beneficiaries of the asset were to sell it shortly after the Donor’s death, it would result in little to no capital gains tax liability to the beneficiaries.

For example, if Mrs. Public had purchased their home long ago for $50,000 and had approximately $50,000 of capital improvements during her lifetime, which would result in her cost basis of the property being equal to $100,000. Let’s assume the Mrs. Public transferred this property to an irrevocable Medicaid trust and upon her death the property was worth $400,000. Upon her death, the beneficiary of this property would receive a cost basis equal to its fair market value of $400,000. If the beneficiary then sold the property for approximately $400,000, which is the fair market value, there would be no capital gains tax to be paid by the beneficiary.

This should be contrasted with individuals who opt to give away their home or other highly appreciated rental property to their children prior to their demise; as such a transaction would result in what is known as a carryover basis in the hands of the donee/beneficiary. A carryover basis means that the donee/beneficiary of the property transferred during life would be the same cost basis that it was in the hands of the Donor immediately prior to the transfer.

In our example, that would mean that the donee/beneficiary, the child, would have a cost basis in this real estate equal to $100,000. In the event the donee/beneficiary sold the property following the death of Mrs. Public, there would be a capital gain equal to $300,000 ($400,000 - $100,000) and assuming at 20% federal capital gains tax rate, a 5% state capital gains rate and applying the new net investment income tax rate of 3.8% that would result in a capital gains tax of approximately $86,400. The Medicaid irrevocable trust’s ability to preserve this step-up in basis benefit is extremely important. This basis step-up would apply to not only real estate, but any investment portfolios or stocks transferred to the trust that may have appreciated over time. See I.R.C. §§ 1014, 2016.

**Planning Note:** It is important to remember that any net rental income generated from the property will be available to the donor of the trust under the terms of the trust, and as such will also be available to the nursing home for MassHealth purposes.

**Question: Do I have to sell my assets inside my investment portfolio prior to transferring them into the trust?**

**Answer:** No. In general, the funding of an irrevocable trust does not result in any income tax related issues whatsoever. In other words, when a trust is funded, it generally means nothing more than retitling the existing assets to the name of the trust. If you have an investment account at Fidelity, you are likely to receive a statement from Fidelity and it generally comes in your name, which is indicated in the upper left hand corner of the statement.

Once this Fidelity account has been successfully retitled to the name of the irrevocable trust, you, as Donor of the trust, will continue to receive these same statements from Fidelity with all the same investments listed on them, the only difference will be that the name of the irrevocable trust along with the trustee’s name will appear in the upper left hand corner of the statement. Therefore, there is no adverse income tax consequences associated with retitling assets to the trust as nothing was sold prior to the transfer.

**Question: How do I transfer real estate to the irrevocable Medicaid trusts and are there any adverse income tax consequences?**

**Answer:** The funding of a trust with real estate is generally done through the preparation of a new Quitclaim Deed. The deed simply transfers the property from the individual name of the Donor to the name of the trustee of the irrevocable trust. The new deed and a trustee certificate will then be filed at the registry of deeds. There will be no adverse income tax consequences associated with this transfer nor is there any gift tax liability due.

**Question: Are there any investment limitations on the trustee of a trust?**

**Answer:** The trustee of a trust can invest in all of the same investment options that would be available to an individual and therefore are not limited by having the assets invested inside a trust. However, the trustee should follow the prudent investment rule as a guide towards making investment decisions. The only caveat, of course, is that there are no individual retirement accounts owned inside of an irrevocable trust as mentioned above.

**Question: Can these irrevocable trusts be changed in any way after they are created and, if so, how?**

**Answer:** While the trust is irrevocable, it nevertheless can be changed through the use of a limited power of appointment, as mentioned above. This is a power in the trust in which the Donor is granted the ability to change the beneficiaries of the trust but generally are limited to a class consisting of the Donor’s children of all generations and charities but specifically excludes the Donor, Donor’s creditors, Donor’s estate or creditors of the Donor’s estate. This power enables the Donor to retain a significant degree of flexibility to adjust their wishes as life events unfold after the creation of the trust. This power is a testamentary power of appointment and is only exercised thru the Donor’s will following his death in which the will references this power.

For example, a Donor may wish to leave a little more assets to grandchildren or perhaps may find that one child is doing extremely well financially while another child is struggling and may desire to reallocate the percentages in which the children are to receive assets, all of which can be done through the use of exercising this limited power of appointment. However, you cannot add a person as a beneficiary to the trust who was not already a member of the class of beneficiaries. The class of beneficiaries can be increased to included siblings or nieces and nephews or as needed to accommodate each any family situation. Sometimes making the class larger when the trust is initially drafted may provide even greater flexibility later.

**Question: Can I add assets to the irrevocable trust many years later?**

**Answer:** Yes, assets can be added to the irrevocable trust at any time after the trust has been created. However, the addition of assets to the trust will result in the creation of a new five year lookback period, but the lookback period will be associated only with those assets that were transferred. The creation of this new lookback period for those newly transferred assets will in no way affect the lookback period for previously contributed assets. In other words, if you had contributed assets to the trust five years earlier and only now wish to put additional assets into the trust, the assets that were put into the trust five years earlier will remain protected from the cost of long term care and this new lookback period will only apply to these newly added assets.

**Question: Is it important to use one or two irrevocable trusts when doing this type of asset protection planning?**

**Answer:** If you are single, then only one irrevocable trust would be needed. However, if you are married and the value of your assets exceed $1,000,000 in Massachusetts, $1,500,000 in Rhode Island or $2,000,000 if you live in Connecticut, or may exceed any of these state exemption amounts over the balance of your lifetime, then you should consider two irrevocable trusts. The reasoning behind two irrevocable trusts is to help you more fully utilize both of your federal and state estate tax exemption equivalent amounts, thereby serving to reduce your estate tax liability. In other words, these Medicaid irrevocable trusts can also help you reduce your estate tax liability while serving to protect your assets from the cost of long term care at the same time. A discussion on the reduction of your estate tax liability and how the trusts are designed to accomplish that is beyond the scope of this letter.

**Question: Can the Donors borrow against any real estate that has been transferred to the irrevocable trust?**

**Answer:** Once real estate has been transferred to these irrevocable trusts, generally you cannot borrow against the property any more. This is generally not a concern for many of the elderly folks who do this type of planning as they have paid off their mortgages and are not interested in going into debt any more. In the event you happen to have an existing mortgage on the property but wish to transfer it into one of these irrevocable trusts, the transfer of the encumbered property will include the retention of a life estate and will not trigger the due on sale clause but you will be prohibited from refinancing such debt. Therefore, it is important that any such encumbered property being transferred to the trust have a fixed rate mortgage for the life of the loan.

If borrowing against the property in the future is of importance to you, then it is recommended that you establish a home equity line of credit prior to transferring such property to the irrevocable trust. This will enable you to borrow against that equity line after the property has been transferred to the trust. Once the equity line expires, however, you would not be able to renew it.

**Conclusion**

One thing is clear, that the scrutiny of these Medicaid irrevocable income only trusts will continue. However it is equally clear that the effectiveness of these trusts will be based upon the language used in drafting them. Nevertheless, these trusts remain an acceptable planning tool when it comes to protecting assets from the cost of long term care.

1. General Laws c. 190B, § 7-401, was repealed when the Massachusetts Uniform Trust Code (“MUTC”) was enacted. See St. 2012, c. 140, § 51. However, the MUTC provides for specific powers of the trustee that are substantially similar. G.L. c. 203E, § 816. [↑](#footnote-ref-1)