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THE PLANNER

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A monthly newsletter for Accounting, and Financial Professionals with a focusing on Estate Planning, Elder Law, and Special Needs Persons.

The Planner is a newsletter to inform and educate Accounting and Financial Professionals of the ever changing areas of estate taxes, and elder law to better service their clients.

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Louis Lepore is an attorney admitted to practice law in the states of New York, New Jersey, and Florida. He has dedicated his practice of law to providing quality legal representation and personal attention to all of his clients on Estate Planning, Elder Law issues, Probate, Business Succession Planning, Asset Protection, Tax and Business Planning.

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Using Advanced Irrevocable Trusts for Income and Estate Tax Savings: Making 2012 Count

"The next nine months are an exceptional window of opportunity for your clients to make family wealth transfers. The federal gift and estate tax exemption is $5,120,000, and both income tax rates and interest rates are at the lowest point in a generation. With federal deficit spending also at record levels, tax and interest rates seem sure to rise. Unless the President, the Senate, and the House of Representatives all agree otherwise, income and estate taxes will increase dramatically on January 1, 2013.

There is also the risk that long-used planning strategies such as charitable deductions and valuation adjustments will soon be eliminated or limited. Advisors who understand this situation will be well positioned to help their clients take full advantage of this estate planning opportunity while it lasts.

In this edition of The Planner, we will explore how the current deficit spending is making the case to increase taxes, what your clients can expect in 2013 unless the President, the Senate, and the House of Representatives all agree otherwise, and how you can help your clients use advanced irrevocable trusts now to take advantage of this opportunity and save income and estate taxes.

The Case for New Taxes

The U.S. government is spending a lot more money than it is taking in, creating the largest deficits in our history. The projection for 2012 is:

U.S. Tax Revenue.....$2,310,000,000,000
U.S. Government Spending.....$3,614,000,000,000
New Debt.....$1,303,000,000,000
National Debt.....$15,114,000,000,000
Recent Federal Budget Cuts.....$385,000,000,000

These are staggeringly large numbers. It's easy to lose sight of their meaning because there are so many zeros at the end of each one. But if you drop eight of the zeros and consider this to be the budget for a young family or single adult, the numbers take on real meaning:

Annual Income..... $23,100
Money Spent..... $36,140
New Credit Card Debt..... $13,030
Outstanding Credit Card Debt..... $151,140
Total Budget Cuts..... $3,850

The advisory team can help the owner change his focus from how much he is making today to the future rewards he can be building for his family and his retirement.

Both are train wrecks waiting to happen. Spending is more than 150% of income, yet budget cuts planned are less than 17% of income. Talk about "Another day older and deeper in debt"!

For the federal government, it seems that either deeper budget cuts will have to be made, or income…in the form of taxes …will have to increase. The federal government can also print more money, which will eventually lead to inflation.

The Year-End Review

In 2012, the federal estate, gift, and generation-skipping transfer tax (GSTT) exemptions are all $5,120,000 and the tax rate on any excess is 35%. Unless the President, the Senate, and the House of Representatives all agree otherwise, on January 1, all three exemptions will drop to $1,390,000 plus an adjustment for 2012 inflation and the tax rate on any excess will start at 45% and increase to 55%. In addition, the estate and gift tax "portability" provision will expire.

The Legal Audit

This is a review of all legal documents of the business, including organizational documents, employment agreements, leases, loan documents and guarantees, and buy/sell agreements. It provides another opportunity to look for tax savings and a way to identify potential gaps or liabilities.

Unless the President, the Senate, and the House of Representatives all agree otherwise, taxes on income, dividends, and long-term capital gains, will also increase on January 1. In addition, a new 3.8% healthcare surcharge will go into effect for married taxpayers with adjusted gross income (AGI) of $250,000 or more ($200,000 or more for single taxpayers). Here's a chart to show the income tax rate change:

LONG TERM GAINS, ORDINARY INCOME & SHORT-TEM GAINS

	2012	2013	2014	2015
TOP FEDERAL TAX	15%	20%	35%	39.8%
HEALTHCARE SURCHARGE	0%	3.8%	0%	3.8%
TOTAL	15%	23.8%	35%	43.6%

Unless the President, the Senate, and the House of Representatives all agree otherwise, your clients' favorable tax-planning window will close in January:

The most favorable estate/gift tax we have ever had will be gone ($5 million exemption to $1 million; 35% rate to 55% rate).

- Interest rates, now at lows not seen in our lifetimes (2% overall, 1.4% AFR for intra-family gifts), will almost surely increase.
- Charitable deductions, now fully deductible, may be limited to those in a 28% income tax bracket.
- Long-term capital gain rates will increase from 15% to 20%.
- Dividend rates will increase from 15% to ordinary income rates, which can be as high as 43.6%.
- Valuation adjustments for family controlled limited partnerships and limited liability companies may be legislated or regulated away.

Planning Tip: Encourage your clients to complete their planning before the end of 2012 to take advantage of this unique planning window.

Irrevocable Trusts Can Help Your Clients

There are a wide variety of irrevocable trusts that your clients can use now to help save income and estate taxes. These include:

- 2503(c) Minor's Trust: Used instead of a Uniform Transfers to Minors Account (UTMA) or Uniform Gifts to Minors Account (UGMA), must provide that any remaining trust assets will pass to the child on reaching age 21.
- Family Bank Trust: An inter vivos bypass trust that mimics the tax avoidance benefits available after one spouse passes away but lets you have these benefits while someone is living.
- Gifting Trust: Used for lifetime annual exclusion gifts (currently $13,000 per donor per donee) to children, grandchildren, and others to avoid the problem of the beneficiary having full control of sizeable assets at age 18 or 21.
- Health and Education Exclusion Trust (HEET): Requires a significant charity beneficiary. For non-charity beneficiaries, distributions are limited to payments directly to an institution that is providing health care or education. Because of these limitations, neither contributions to nor distributions from the HEET are taxable. The HEET is especially useful when the client's GSTT exemption has already been used.
- Intentionally Defective Grantor Trust (IDGT) or Intentional Trust: Allows your client to use taxes on trust income to reduce his or her estate taxes. The grantor's paying the income tax due because of the trust's income is not an additional gift to the trust.
- Inheritor's Trust: Created at the beneficiary's request for the benefit of a beneficiary. Typically used when a grandparent or parent doesn't want to go to the trouble to create a trust that would keep their resources out of the beneficiary's estate when they die. (E.g., the physician beneficiary who already has a taxable estate and wants

asset protection for the inheritance.) The beneficiary's child, sibling, friend, or spouse can set up the inheritor's trust.

- Life Insurance Trust: Set up by someone to hold life insurance on his or her life. Variations to the single-life insurance policy trust include second-to-die policy trust and spousal access life insurance trust.

- Split-Interest Charitable Trusts: Charitable remainder trusts and charitable lead trusts.

Planning Tip: Current interest rates, as low as they are, make charitable remainder trusts the least attractive, and charitable lead trusts the most attractive, they have been in a very long time, if ever.

- Split-Interest Non-Charitable Trusts: These include grantor retained annuity trusts (GRATs), grantor retained income trusts (GRITs), qualified personal residence trusts (QPRTs) and qualified terminal interest property trusts (QTIPs).

There are also a several types of irrevocable trusts that your clients with particular situations can establish now that have purposes other than saving income and estate taxes. These include:

- Special Needs Trust: Allows for provision of additional benefits and services for family members with special needs (children, parents) without disrupting valuable government benefits.

- Retirement Trusts (Stand Alone): Designed specifically to ensure the maximum stretch out for tax-deferred plans after the participant/owner's death.

Amending an Irrevocable Trust

Even though an irrevocable trust once established cannot be revoked or amended by the trustmaker, careful planning at its establishment can empower someone other than the trustmaker to make changes. For example, a lifetime power of appointment given to someone other than the trustmaker can allow the term of the trust to be extended or a beneficiary (including a charity) to be added or dropped. Assets can be sold by the trustee to a new irrevocable trust with different beneficiaries and provisions. Non-judicial modification is allowed under the Uniform Trust Code if the trustmaker, trustee, and all beneficiaries agree. Decanting (transferring to another trust for the same beneficiaries) is a trust feature that is now allowed in 14 states, with four more pending.

Planning Tip: A trust protector, whose role differs from a trustee's and is common in offshore jurisdictions, is now often being used in domestic irrevocable trusts to allow for more flexibility without adverse tax consequences.

The Family Bank Trust

An inter vivos bypass trust can create a lifetime benefit for the grantor with assets he or she "gives away." For example, a wife can create a family bank trust with appreciating assets. As the trustee, her husband has access to the assets, can withdraw them and can even lend or give them back to his wife. Because they live in the same household, both will enjoy the benefits. A limited power of appointment can be given to the husband in the event he should die before she does and he can even appoint the property back to his wife.

Generation Skipping Transfer Tax (GSTT) Exemptions

There are two GSTT exclusions. There is an annual exclusion (currently $13,000 per year per done per donor) for outright gifts and gifts to qualifying trusts. To be a qualifying trust, a trust must have only one current beneficiary and have provisions that will cause the trust assets to be included in the beneficiary's estate for estate tax purposes. There is also the lifetime GST exemption ($5,120,000 million in 2012) that can be applied to transfers to non-qualifying trusts such as dynasty trusts and trusts with multiple beneficiaries.

The Lifetime QTIP Trust

This is a split-interest trust. It is created by one "propertied" spouse for the benefit of the other "non-propertied" spouse as a method of equalizing the estates without the propertied spouse giving up control. All income must be paid at least annually to the beneficiary spouse to qualify gifts to the trust for the gift tax marital deduction.

During the life of the beneficiary spouse, the QTIP trust can be a spendthrift trust, but any income that is generated in the QTIP trust is subject to attachment by the beneficiary spouse's creditors. To qualify gifts to the trust for the gift tax marital deduction, the QTIP election must be timely made on the donor spouse's Form 709 gift tax return and there is no cure if the return filing deadline is missed. The death of the beneficiary spouse before the donor spouse renders the beneficiary spouse the transferor for future trusts to which the QTIP trust assets are appointed. The donor spouse's GSTT exemption can be allocated to the QTIP trust.

Grantor Trusts and Wealth Transfer

The balance of this newsletter will focus on various grantor trusts. Tax code sections 671-679, which define and govern "grantor" trusts, were written in the 1950s as a deterrent to taxpayers transferring their assets to trusts to remove the assets from their estate to take advantage of the then-lower income tax

brackets and rates that trusts enjoyed. If a trust is a grantor trust, these sections cause attribution to the grantor of all income and deductions associated with the trust assets. Some, but not all, trust characteristics that will cause a trust to be a grantor trust will also cause the trust's assets to be included in the grantor's estate for estate tax and GSTT purposes.

Today, the grantor trust income and deduction attribution is used by estate planners in several ways to the taxpayer's advantage. For example, a transfer of appreciated assets (real estate, stock portfolio, privately owned business) to a grantor trust is not an income tax recognition event. So, too, transferring assets to a grantor trust before they appreciate allows future appreciation to be removed from the grantor's estate.

Another grantor trust use is the "tax burn," which occurs when the grantor pays the income tax on income the grantor trust generates, thereby removing assets from the estate without using any of the grantor's annual exclusion or lifetime exemption from gift taxes. The grantor trust is also a permissible purchaser of existing insurance on the grantor's life, which avoids the transfer for value rules.

Planning Tip: Careful drafting of grantor trust provisions can provide certainty while giving more flexibility. For example, should the income being generated by the trust cause the grantor to pay more in income taxes than desired, if the trust is properly drafted the grantor trust provision can be turned off without affecting the estate tax exclusion feature of the trust. The trustee can also be given the discretion to reimburse the grantor for income taxes paid because of the income attribution.

Planning Tip: For income tax reporting, the trust can have its own tax identification number, in which case a Form 1041 is required, or the grantor's social security number can be used with no 1041 required.

Creating Lifetime Benefits

A grantor trust can allow loans to the grantor. For example, the trustee can borrow against a life insurance policy or the trust assets and re-loan the proceeds to the grantor. If adequately documented and secured, there should be no "incidents of ownership" that would cause the trust assets to be brought back into the grantor's estate. The entire loan balance, including any accrued interest at the grantor's death, would reduce the grantor's estate. Making the loan interest commercially reasonable but higher than that required by law can be used to remove even more from the grantor's estate—another example of "tax burning."

Irrevocable Life Insurance Trust (ILIT)

An ILIT lets your client remove life insurance death benefits and policy cash value from your client's taxable estate, control the disposition of the death proceeds, and utilize the annual gift tax exclusion (currently $13,000 per person) for "Crummey" gifts to the trust so it can pay insurance premiums. It provides asset protection for the proceeds and creates liquidity at the grantor's death by giving the trustee authorization to lend proceeds to the estate (to pay estate taxes and other expenses) and to buy assets from the estate.

Planning Tip: In community property states, the non-insured spouse cannot contribute to the trust of which he or she is a beneficiary without causing inclusion in the beneficiary spouse's estate. If the insured spouse does not have separate property sufficient to make the contribution, a partition agreement can solve this issue.

Sales to Grantor Trusts

With the current $5 million gift tax exemption, commercially reasonable installment sales to grantor trusts are now more commonly available to use and so are often preferred to grantor retained annuity trusts (GRATs). A sale provides more tax certainty than a GRAT because, for estate tax purposes, trust assets are included in the grantor's estate if the Grantor dies during the GRAT term.

To make the sale commercially reasonable, the grantor establishes an intentionally defective grantor trust, contributes assets to it and allocates GSTT exemption to the gift. This gift serves as the security for an installment sale of assets having a value many times that of the initial gift. It is common for the grantor's gift to be 10% of the value of the assets sold, but as an alternative, financially solvent trust beneficiaries can guarantee the trust's performance under the sale agreement.

Asset Protection Trusts and Self-Settled Trusts

Whether creditors can reach a beneficiary's interest in an irrevocable trust established by a third party is determined based on the enforceability of the trust's spendthrift provisions, the beneficiary's degree of control of the trust, and whether the beneficiary has an interest in the trust property. Typically, no creditor protection is provided for the grantor of a trust who is also the trust's beneficiary. Such trusts are called "self settled." There are, however, certain states (see below) and some offshore jurisdictions whose statutes provide grantors of certain types of self-settled trusts protection from some or all creditors. Common types of self-settled trusts include revocable living trusts, charitable remainder trusts and grantor retained annuity trusts. A grantor's judgment creditors can reach the grantor's

interest in the assets in these types of trusts. Creditors can also reach mandatory distributions to beneficiaries such as the income interest in QTIPs, GRTs and CRTs.

Planning Tip: It is especially important not to include mandatory distributions to a beneficiary from a special needs trust.

Planning Tip: A special needs trust funded with assets that require mandatory distributions (such as a 401(k) or IRA) should not be a "conduit" trust.

The states that currently provide creditor protection for certain self-settled trusts (domestic asset protection) are: Alaska, Delaware, Nevada, Rhode Island, Utah, South Dakota, Oklahoma, Missouri, Tennessee, New Hampshire, Wyoming, and Colorado (a Virginia statute is on the Governor's desk).

Planning Tip: Your client will want to weigh the costs and benefits of a self-settled trust vs. a non-self-settled trust, equitable division in case of divorce, and offshore vs. domestic asset protection trusts.
Split-Interest Grantor Trusts

These are techniques for leveraging gifts with distinct economic interests, with a division over time of ownership and the type of interest. The portion that is given away (the remainder) is taxed as a gift; that which is not given away is a retained benefit and is not taxed as a gift. Common split-interest trusts include charitable remainder and lead trusts (CRTs, CLTs), grantor retained annuity trusts (GRATs) and qualified personal residence trusts (QPRTs).

Chapter 14 of the Internal Revenue Code was designed to reduce intra-family undervaluations of split-interest transfers and valuation provisions were put in place. Fixed annuity or unitrust amounts, exceptions under Code Sec. 2702, are most commonly used.

Planning Tip: Split-interest trust tax calculations are made using the Code Sec. 7520 rate (120% of the federal mid-term applicable federal rate (AFR)) at the time the trust is established. Current low interest rates (mid-term AFR of 1.3% and 7520 rate of 1.56% are record lows) allow a grantor to make very large gifts to his/her family without using the gift tax exemption by using split-interest trusts.

Planning Tip: The GSTT exemption can only be applied at the end of the estate tax inclusion period (ETIP). This is the time during which, if the grantor dies, the property will revert to the grantor's gross estate. For example, if a QPRT is established for a ten-year period, the GSTT exemption can only be determined and applied at the end of the ten years when it is known that the grantor has survived the trust term and the property will not revert to the grantor's estate. As a result, split-interest trusts are not appropriate for use as dynasty trusts.
Planning Tip: A longer term means more risk that the grantor may not survive the term. Life insurance can be used to offset risk. A split-interest trust may or may not be a grantor trust during or after its initial term.

Grantor Retained Income Trust (GRIT)

With a GRIT, the grantor receives income from the trust assets for a certain length of time, then the remainder is paid to or held for the benefit of a remainder beneficiary. There is significant wealth transfer opportunity with low or non-income producing property. GRITs are no longer available to use with transfers to immediate family members, but they can still be used for business situations and for gifts to nieces and nephews, and are especially useful for non-marital life partners.

Qualified Personal Residence Trust (QPRT)

A QPRT lets the grantor make a gift of his/her personal residence to family members while retaining the right to live in the residence for a term of years. QPRT gift tax calculations assume no appreciation of the home during the primary term. A QPRT is a grantor trust during the trust primary term, so the grantor continues to receive the mortgage interest deduction. The grantor also retains the exclusion under IRC Sec. 121 ($250,000 for a single person, $500,000 for a married couple) if the home is sold during the trust primary term. If the grantor dies during the trust primary term, the residence is included in the grantor's gross estate.

Planning Tip: Use multiple QPRTs of minority interests in the home to hedge the risk of the grantor's and take advantage of the valuation adjustment appropriate for gifts of minority interests in real estate.

Planning Tip: QPRTs have not been used as much lately due to low interest rates. However, if the grantor lives in a state that has a state estate tax and wants to make a gift to a child who expects to live in the house, assuming the grantor survives the term, any state estate tax can be eliminated.

Grantor Retained Annuity Trusts (GRAT)

GRATs are less popular now that the gift tax exemption is $5 million. Nevertheless, they are well-suited for appreciating assets and discounts provide leverage. If the grantor dies during the trust term, the property is included in his/her gross estate. Multiple or "rolling" GRATs (e.g., maturing every two years) can lessen risk

and, over time, provide remainder benefits for the beneficiary.

Conclusion

Our very favorable planning time—with favorable interest rates, estate/gift taxes exemptions and rates, full charitable deductions, low capital gains and dividend rates, and available strategies—is very likely to end on December 31, 2012. The advisor who understands the various irrevocable trusts explained here and the urgency for clients to implement their plans during the balance of 2012 is in a unique position to help clients save substantial estate and income taxes, and will undoubtedly be a highly valued member of the advisory team.

The Value of Using Irrevocable Trusts in Medicaid Planning

People often wonder about the value of using irrevocable trusts in Medicaid planning. Certainly gifting of assets can be done outright, not involving an irrevocable trust. Outright gifts have the advantages of being simple to do with minimal costs involved, including the cost of preparing and recording deeds and the cost of preparing and filing a gift tax return. Many financial institutions have their own documents they use for changing ownership of assets so there are typically no out-of-pocket costs for the transferor.

So, why complicate things with a trust? Why not just keep the planning as simple and inexpensive as possible? The short answer is that gift transaction costs are only part of what needs to be considered. Many important benefits that can result from gifting in trust are forfeited by outright gifting. These benefits are what give value to using irrevocable trusts in Medicaid planning.

Prior to state implementation of the federal Deficit Reduction Act of 2005 (DRA) in recent years (with the exception of California), federal Medicaid law contained a bias against trusts: Most transfers of assets to trusts had a 5-year lookback period, whereas there was a 3-year lookback period for non-trust transfers. This different standard induced many clients to elect outright gifting in preference to gifting in trust. The DRA leveled the playing field by imposing a 5-year lookback period for ALL transfers. Removal of the bias against trusts shifted the discussion of elder law attorneys with clients to the real benefits of gifting in trust versus gifting outright.

Key benefits of gifting in trust are:

- Asset protection from future creditors of beneficiaries
- Preservation of the Section 121 exclusion of capital gain upon sale of the settlors' principal residence (the settlor is the trustmaker)
- Preservation of step-up of basis upon death of the settlors
- Ability to select whether the settlors or the beneficiaries of the trust will be taxable as to trust income
- Ability to design who will receive the net distributable income generated in the trust
- Ability to make assets in the trust noncountable in regard to the beneficiaries' eligibility for means-based governmental benefits, such as Medicaid and Supplemental Security Income (SSI)
- Ability to specify certain terms and incentives for beneficiaries' use of trust assets
- Ability to decide (through the settlors' other estate planning documents) which beneficiaries will receive what share, if any, of remaining trust assets after the settlors die
- Ability to determine who will receive any trust assets after the deaths of the initial beneficiaries
- Possible avoidance of need to file a federal gift tax return due to asset transfer to the trust.

We will briefly discuss each of these potential benefits in sequence. Each of these potential benefits depends on the specific language selected in the design and drafting the trust. None of them is automatic or inherent in every trust. Thoughtful planning and careful drafting is necessary to take advantage of the benefits available, thus it is important to understand how and why each benefit comes about. This issue of the Planner newsletter is just an introduction to these topics, not a specific drafting guide. We are available to discuss any of these issues in more detail.

Asset Protection from Future Creditors of Beneficiaries

A central benefit of gifting in trust is to protect the gifted assets from the creditors and predators of the beneficiaries. This is accomplished by means of a spendthrift provision – special provisions in the trust that make trust assets not subject to attachment, foreclosure, garnishment, or a laundry list of undesirable actions by the creditors of the beneficiaries.

Preservation of Section 121 Exclusion of Capital Gain on Sale of Principal Residence

Section 121 of the Internal Revenue Code (Tax Code) creates an exclusion from capital gains tax of up to $250,000 of capital gain in the taxpayer's principal residence when it is sold if the taxpayer owned and lived in it at least two of the past five years before the sale (only one of the past five years if the homeowner had to move to a nursing home). If there are two qualifying co-owners, they can each exclude $250,000 of gain upon sale in such circumstances. This is a very valuable benefit that has been in the Tax Code since 1997. A trust can preserve this benefit if it is a "complete grantor trust" – a grantor trust as to both income and principal. On the other hand, a residence gifted outright to someone and then sold by the successor would need to qualify for the Section 121 exclusion based on the ownership of the donee to avoid capital gain in excess of the adjusted cost basis of the donor. Our senior population often has owned their home since the late 1940s, 1950s or 1960s, so a huge amount of appreciation in value

has occurred since then.

Preservation of Step-Up of Basis

When an appreciated asset is included in a decedent's taxable estate for federal estate tax purposes, it receives step-up (or down) of basis to the date of death value under Section 1014 of the Tax Code. Normally gifted assets pass to gift donees with "pass through basis"; that is, the donees receive the assets with the donor's adjusted cost basis, rather than the date of gift value of the assets. If, however, something pulls the assets back into the taxable estate of the donor upon the donor's death, the donee will own the asset at that point with the donor's date of death value as his or her basis, rather than the donor's original adjusted cost basis. For highly appreciated assets, such as the donor's home or stocks that he or she owned for a long time, obtaining step-up of basis can be a huge benefit for minimizing or eliminating capital gains tax when the donee later sells the assets. This benefit of step-up in basis can easily be forfeited by outright gifting. However, a provision in an irrevocable trust that pulls the property back into the taxable estate of the settlor upon the death of the settlor can preserve step-up of basis for benefit of the donee. With the amount of assets that can pass free of federal estate tax being well beyond the value of most Medicaid planning clients' estates, estate inclusion and step-up of basis is generally a great benefit to design into the trust, without any actual tax liability. A Limited Power of Appointment retained by the settlor can accomplish this. Other provisions can also cause taxable estate inclusion.

Ability to Select Whether Trust Income is Taxable to Settlors or Beneficiaries

This brings us to the topic of "grantor trusts." Grantor trusts are treated by the Tax Code as "owned" by the settlor (also called the grantor) for income tax purposes. As mentioned above, preservation of the Section 121 exclusion of capital gain upon the trustee's sale of the settlor's primary residence that was earlier funded into the trust requires that the trust be a "grantor trust" as to both income and principal. The creation and significance of grantor versus nongrantor trust status takes an entire seminar or article unto itself, so can only be touched upon lightly here. But the choice of whether a trust will be a grantor or nongrantor trust and how that will be accomplished are key design decisions. For example, it may be important that income generated in the trust not be taxed to the settlor. This requires nongrantor trust status, which necessitates that every trust provision that would cause grantor trust status be avoided in the drafting of the trust. In other examples, however, grantor trust status is important as a goal for tax reasons, or if the settlors are to receive income from the trust.

Ability to Design Who Will Receive Trust Income

Unlike an outright gift, by which the donor gives up the right to receive income generated by the transferred assets, an irrevocable trust can be designed so funding constitutes a completed gift for Medicaid purposes although the settlor reserves the right to receive income from the trust. This is an attractive option for some seniors, although it does result in an inherent downside for Medicaid planning purposes: Any income that the trustee has the power to distribute to the settlor will be counted for Medicaid eligibility purposes, even if the trustee decides not to actually distribute the income to settlor. Some seniors avoid trustee discretion by making distribution of all trust net income to them mandatory, rather than discretionary. In this case, the income would also be counted for Medicaid eligibility purposes as well. Others go the entirely opposite direction by prohibiting the trustee from distributing any income to the settlor, thereby ensuring that trust income will not be part of the settlor's cost of care budget when the settlor is on Medicaid. There are several factors to weigh in such decision-making, but the key point for this discussion is that use of an irrevocable trust in Medicaid planning gives the client these design choices, whereas an outright gift does not.

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

It is a sad fact that an outright gift or bequest from a donor, such as a parent, to a disabled donee can result in the donee becoming ineligible for means-based governmental benefits that he or she was eligible for before the gift or bequest, or soon would have become eligible for. In such situations, unless irrevocable trust planning is then done to establish a "self-settled special needs trust," the gifted or bequeathed assets typically get consumed for the donee's care and once they are gone, the donee goes onto the governmental benefits from which the gift or bequest disqualified him or her until consumed. One way of looking at this outcome is that the indirect recipient of the gift or bequest was the governmental benefit program from which the gift disqualified the disabled person for a period of time. This is generally considered poor planning.

Better planning is for the gift or bequest to be made in an irrevocable special needs trust for benefit of the disabled beneficiary, so the gift or bequest will be managed to enhance the living conditions of the disabled beneficiary by paying for things that the governmental benefits do not pay for. If a disabled person becomes entitled to an outright gift or bequest, or an outright gift or bequest recipient later becomes disabled, depending on the age of the disabled person, it may be possible to establish a "self-settled special needs trust" for the disabled beneficiary. Such trusts (funded with assets of the disabled person) must contain a provision stating that upon the death of the disabled beneficiary any remaining trust assets must pay back the state up to the full amount of Medicaid benefits received by the beneficiary, and only after the state is reimbursed may any excess pass to other beneficiaries such as other relatives. The payback provision requirement is Congress's "quid pro quo" – the balancing deal that makes it fair for the disabled person's otherwise disqualifying assets to be set aside in a Medicaid- and Supplemental Security Income-noncountable trust that is nonetheless able to be consumed by the trustee for benefit of the disabled person to supplement but not replace the governmental benefits.

Ability to Specify Terms and Incentives for Beneficiaries' Use of Trust Assets

Many parents or grandparents desire to infuse their planning for their children or grandchildren with positive aspirations. Such goals may be as simple as that the gifts or bequests may only be used for the recipients' education, to finance a career change or buy a home. Or the goals may be more serious, for example, establishing that the intended recipient will only become eligible to receive the gift or bequest if he or she participates in a drug or alcohol rehabilitation program or gives up some other behavior that the donor wants to create an incentive for the donee to abandon. Such planning goals of a client almost always indicate an irrevocable trust with beneficiary incentive provisions as the vehicle to implement the plan. This is completely compatible with Medicaid asset protection planning for seniors at the same time.

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

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

Ability to Determine Successor Beneficiaries

A major concern in Medicaid asset protection planning and estate planning in general is who will be the successor beneficiaries of anything a client leaves to someone. If the gift or bequest passes outright, the recipient has control through lifetime consumption of assets and income or through his or her estate plan, to determine who will receive anything that the initial recipient doesn't use up. Of course, the recipient's creditors or predators also may gain control over the assets and income gifted outright to the initial recipient. If the client would prefer to designate that only blood descendants, or descendants and their spouses, and/or certain charities will receive what is not consumed by the initial recipient, an irrevocable trust is a key instrument to create such a plan. This is true almost regardless of the initial size of the gift or bequest – if a modest amount of funds are left in trust, there may nevertheless be a remainder to pass to a successor beneficiary or even another successor beneficiary. This sounds like a "dynasty trust" and it actually is, even though it is of modest size. The point is that by use of an irrevocable trust, the client has the option to decide who the possible recipients will be, and even to grant limited powers of appointment to the named recipients in order to give them some control as well.

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

A goal of many planners in design of irrevocable trusts is to make the initial trust-funding gift(s) "incomplete" for tax purposes. The purpose is generally to prevent the settlor from having to file a federal gift tax return for the year(s) of the funding transaction(s), assuming that the taxpayer makes no other "taxable gifts" in any such year.

There is a split of authority with the Internal Revenue Service concerning when transfers to an irrevocable trust are considered "complete," thus requiring the filing of an income tax return. Normally there will not be any gift tax due (the current laws allow an individual to give away $5 million in assets during her lifetime without paying any tax on the gift) but it is important to follow the rules that do require filing a gift tax return, even if no tax is due. We are happy to assist with this analysis.

Conclusion

The above discussions demonstrate that use of irrevocable trusts in Medicaid planning, as in other fields of estate planning, provides many opportunities to create great benefits beyond simply transferring assets. Some or most of these benefits may be achieved through the use of an irrevocable trust. If care is taken to include the desired provisions, an irrevocable trust can greatly enhance the value of the clients' Medicaid planning beyond what can be accomplished through outright gifting.

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