

Medicaid Trusts

by Thomas D. Begley, Jr.

1. Medicaid-Qualifying Trusts

Trusts established and funded on or before August 10, 1993, are governed by the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) and trusts established and funded after August 10, 1993, are governed by OBRA-93. 42 U.S.C. § 1396a(k) and 1396p.

A Medicaid-Qualifying Trust (MQT) was defined under COBRA as a trust or similar legal device that:

1. Was established, other than by will, by an individual or an individual's spouse;
2. Under which the individual may be the beneficiary of all or part of the payments (principal and income) from the trust; and
3. The distribution of the payments is determined by one or more trustees, who are permitted to exercise any discretion with respect to the distribution to the individual.

All three of these criteria must be present for the trust to be an MQT. An MQT actually disqualified the beneficiary from Medicaid. There were several types of trusts under COBRA that did not disqualify the beneficiary from Medicaid. These included:

- Testamentary trusts;
- Irrevocable trusts created by third parties, such as family members other than the beneficiary's spouse, for the benefit of the Medicaid beneficiary;
- Trusts created by a conservator or guardian of an incapacitated or protected person;
- Court-created income trusts for an incapacitated individual.

2. Overview of Trusts Under OBRA-93

a. Types of Trusts

As previously mentioned, trusts established and funded after August 10, 1993, are governed by OBRA-93. The MQT rules were repealed by OBRA-93, and new rules for revocable and irrevocable trusts created after August 10, 1993 were established. OBRA-93 also created special disability trusts, each of which has special rules. These trusts are under-65 disability trusts and pooled trusts. OBRA-93 also established a Miller trust, to be used when a potential Medicaid recipient has income in excess of the income cap. The fourth trust authorized under OBRA-93 is a sole benefit of trust.

b. What Constitutes a Transfer to or from a Trust

The key to understanding the transfer rules pertaining to trusts is to understand when the transfer has taken place. If there is a transfer from an individual *to* a trust under conditions by which the trust assets are still available to the individual, for Medicaid purposes there has been no transfer. Therefore, where the trust is revocable, the assets are still available to the individual after the trust is funded so there is no transfer at this point. The transfer is considered to have taken place on the date of payment *from* the trust to the third party.

If the trust is irrevocable, the transfer is considered to have been made as of the date the trust was established, or upon such later date that payment to the settlor was foreclosed. However, if the settlor can still benefit from the assets with which the trust is funded, those assets are still available, and there is no deemed transfer. If and when those assets are paid out to a third party, the transfer occurs. If the settlor places assets in an irrevocable trust and can no longer benefit from any of the trust corpus, there has been a transfer of assets when the trust is funded. 42 U.S.C. § 1396p(c)(1)(B); HCFA Transmittal 64 § 3258.4E.

There currently are no federal regulations pertaining to trusts under OBRA-93. However, guidelines are found at HCFA Transmittal 64 § 3259. A trust is defined as including any legal instrument or device that is similar to a trust, but not including testamentary trusts. 42 U.S.C. § 1396p(d)(6); HCFA Transmittal 64 § 3259.1A1. The individual is considered to have established the trust if the individual's assets were used to fund the trust, and if the trust was established by the individual, the individual's spouse, a person (including a court or administrative body) acting on behalf of the individual or the individual's spouse, or a person (including a court or administrative body) acting at the direction of the individual or the individual's spouse.

3. Revocable Trusts

The entire corpus of a revocable trust is an available resource. 42 U.S.C. § 1396p(d)(3)(A); HCFA Transmittal 64 § 3259.6A. Payments to the trust are not transfers because the assets remain

available. Payments to or for the benefit of the individual are counted as income. Payments to third parties are considered transfers. The lookback period for transfers *from* these trusts is 60 months.

4. Irrevocable Retained Interest Trusts

Payments from income or principal from an irrevocable trust paid to or for the benefit of the individual are treated as income. If income could be paid for the benefit of the individual, it is treated as an available resource. Any portion of the corpus that could be paid to or for the benefit of the individual is also treated as an available resource. HCFA Transmittal 64 § 3259.6.

In *E.J. v. Neeham A.H.S.*, OAL Dkt. No. HMA-2579-00, N.J. and B.J. established an irrevocable trust containing the following language: “Trustee’s Powers ... to distribute to each Grantor upon his or her demand, all of the assets herein, provided, such Grantor is able to or replaces the value of such assets in the Trust within twenty-four (24) hours of such withdrawal.”

The Administrative Law Judge determined that under this language the grantors retained the discretion to determine whether a distribution should be made to themselves. Since the grantors could reach the funds which are in the trust they should be considered available. *See*.

a. Lookback and Transfer

i) Available Portion of Corpus

To the extent that a portion of the trust corpus is available to the individual, there has been no transfer, and there would be no applicable lookback period. If assets are transferred by the trust from the available portion of the trust to a third party, the lookback is three years under OBRA-93. This is inconsistent with the theory that makes transfers from an available revocable trust subject to a 60-month lookback, but it is the HCFA interpretation, nevertheless. It is also inconsistent with the Deficit Reduction Act, which undoubtedly controls. DRA § 6011(a).

ii) Corpus Unavailable

Where a transfer has been made *to* an irrevocable trust and the corpus of the trust is unavailable to the settlor, the lookback period is 60 months. Transfers *from* the trust assets that were unavailable to the settlor are not considered transfers and there is no applicable lookback period.

Further, where assets are transferred to an income only trust and the settlor has no access to principal, the assets are no longer available to the settlor. The 60-month lookback applies, therefore, and the entire value of the assets transferred to the trust is used in calculating the penalty. The income from the trust is simply income to the settlor-beneficiary and is treated as income. If the trust

provides for distributions to third parties from the principal, such distributions are not additional transfers and are not subject to any lookback rule.

However, to avoid estate recovery most practitioners will advise clients to distribute the corpus of the trust at the time of Medicaid application. New Jersey has taken an unwritten position that such a transfer is a transfer of income and subject to imposition of the Medicaid transfer of asset rules.

5. Non-Retained Interest Trusts

If the principal and income of a trust cannot be distributed to the settlor, then they are not counted in determining Medicaid eligibility, because those assets are no longer available. HCFA Transmittal 64 § 3259.6C. Assets used to fund the trust, however, are considered transfers subject to a 60-month lookback period. The date of the transfer is considered to be the later of the date upon which the trust was established, or the date upon which payment to the individual was foreclosed. If funds are added to the trust after the establishment of the trust, there is a new transfer as of the date of the additional funding.

If assets are transferred from the trust to third parties, they do not result in the imposition of any penalty because the transfer took place when the assets were transferred into the trust.

6. OBRA-93 Rules for Irrevocable Income Only Trusts

a. Purpose

Income only trusts are a means by which seniors may transfer assets to a trust rather than to their children. Seniors tend to view transfers to trusts as protection, while they tend to view transfers to children as gifts. Trusts provide them with a sense of dignity and security.

b. Requirements

Income only trusts are permitted by OBRA-93. 42 U.S.C. § 1396p(d)(3)(B). They must be irrevocable. The trust instrument provides that the grantor or the grantor's spouse receive all of the income from the trust but has no access to principal. The requirements for an income only trust were spelled out in a letter from Sally K. Richardson, Director Medicaid Bureau, Health Care Financing Administration, Department of Health and Human Services, to Elice Fatoullah, dated December 23, 1993. 7 ElderLaw Rep. 2 (Feb. 1994). Subsequently, HCFA clarified the rules in a letter dated February 25, 1998, from Robert A. Streimer, Director, Disabled and Elderly Health Programs Group, Center for Medicaid and State Operations, Health Care Finance Administration, Department of Health and Human Services, to Dana E. Rozansky, of Begley, Begley & Fendrick. 9 ElderLaw Rep. 9 (Apr. 1998).

Under the Richardson letter:

- If there are any circumstances under which either income or principal could be paid to the individual, then actual payments are considered income.
- If principal could be paid to the individual, it is considered an available resource, whether or not it is actually paid.
- If no portion of the principal can be distributed to an individual, *i.e.*, an “income only trust,” then the trust principal is unavailable.
- If some portion of the trust principal could be paid to the grantor but the principal is paid to a third party, there is a 36-month lookback.

This left open the issue of whether a lookback applied for transfers to or from the income only trust. Even the HCFA was not sure which interpretation was correct. Q & A 83, Summary of Verbal Q & A's from HCFA Central to the Regions (Nov. 4, 1993). The Streimer letter clarified these issues by clearly stating that the transfer took place when the assets were transferred to the trust.

c. Design of Trust

i) Income

It is good practice for the trust to provide that all income be distributed to the grantor. From an income tax standpoint, distribution of the income to the grantor avoids income tax at the trust's highly compressed tax rates.

ii) Principal

There can be absolutely no access to principal by either the grantor or the grantor's spouse. If either the grantor or the grantor's spouse has access to principal, the assets in the trust would be “available” for Medicaid eligibility purposes.

iii) Principal Distribution Provisions

The trust should be designed to permit the trustee to make distributions to third parties. Through this mechanism, the trustee can stop income payments to a grantor who will be requiring Medicaid, and can avoid estate recovery in those states that use a broad definition of estate. The

disadvantage to distributing the assets from the income only trust is that the opportunity for a “step up” in basis will be lost.

d. Why Income Only Trusts are Useful

There are a number of reasons why transfers to an income only trust should be considered in lieu of outright transfers to children.

i) Control

Some clients are relatively healthy but are aging and are concerned about the potential cost of their long-term care. Other clients have early stage Alzheimer’s disease and are not convinced that they will ever require nursing home care, but would like to do some planning. For example, suppose an 85-year-old woman who is in relatively good health or who has early stages of Alzheimer’s disease and has \$150,000 of assets wants to preserve a portion of her estate for her children. By transferring the assets to an income only trust, she has the feeling that she has more control over the assets since income is being paid directly to her, rather than through her children. The client feels a greater sense of independence because of this direct payment.

ii) Income Tax

Usually, the elderly client is in a lower income tax bracket than her children. If assets are transferred to the children to hold for the parent, the income earned on those assets is taxed to the children at their higher marginal tax rates. Through use of an income only trust, income will be paid directly to the elderly parent and the tax paid at the elderly parent’s lower tax rates.

iii) Risk Avoidance

If the elderly parent transfers assets to children, rather than puts them in a trust, certain risks must be anticipated. These risks can be avoided if the assets are put in a trust. The risks of an outright transfer include:

- *Claims of creditors.* The claims of the creditors of the adult children could be satisfied through the assets of the parent if the parent makes outright transfers to the children.
- *Matrimonial action.* If a child to whom assets are transferred is subsequently divorced, the transferred assets may become subject to a claim of equitable distribution. While the law dictates that assets transferred from a parent to a child are not subject to equitable distribution, practitioners in the field of family law indicate that judges often find ways to give

additional assets, other than the transferred assets, to the other spouse. In addition, the assets transferred could affect alimony or support rights or obligations.

- *Bad habits.* If a parent transfers assets to a child who is a gambler, a drug addict, an alcoholic, or a spendthrift, the assets may be squandered and no longer be available to the parent.

iv) Financial Aid

If the adult child to whom assets are transferred is applying for financial aid on behalf of a college student, the amount of financial aid may be reduced or eliminated due to the existence of the transferred assets in the name of the adult child.

v) Appreciated Assets

If a parent has highly appreciated assets and transfers them to children, the transfer is subject to carryover basis and will result in the children paying significant capital gains tax in the future. If the highly appreciated assets are transferred to an income only trust, and the trust is structured as a grantor trust so that the assets will be included in the estate of the parent on death, the children will receive a "step up" in basis and will be able to avoid paying significant capital gains taxes. To obtain this benefit the beneficiary must have a limited power of appointment over trust assets.

vi) Timing

Income only trusts can be used in crisis planning but they are even better in situations where it does not appear that Medicaid will be needed for a considerable period of time.

e. Estate Recovery

New Jersey would seek estate recovery from a Medicaid recipient's estate where assets are held in an income only trust because New Jersey uses a broad definition of estate that includes living trusts.

In a situation where there is a married couple, if the income only trust was established for the benefit of the community spouse, the trust assets should not be subject to estate recovery because the deceased Medicaid recipient did not have a legal interest in the trust as of the date of death. New Jersey has taken the position that if any of the trust assets belong to the Medicaid recipient within five years prior to the date of death, the assets are included in his estate for estate recovery purposes.

If a potential Medicaid recipient established an income only trust in a state with a broad definition of estate, a strategy would be to have the trustee make distribution from the trust to a third party prior to the application for Medicaid or, at least, prior to the date of death of the Medicaid recipient. Since the penalty would be calculated on the basis of the transfer into the trust, there should be no further penalty for the distribution from the trust, and that distribution would protect the trust assets from estate recovery.

Care must be taken in drafting the trust so that trust assets are not available to pay debts of the decedent's estate. If assets are available to pay debts of the decedent's estate, they may be subject to Medicaid estate recovery.

f. Elective Share

State Medicaid regulations require that a Medicaid recipient who is predeceased by a spouse assert the Medicaid recipient's right to an elective share against the estate of the predeceased spouse. *N.J.A.C. 10:71-4.10(b)(2)(ii)*. Failure to do so is considered a transfer of assets subject to the Medicaid transfer ineligibility rules. If an income only trust provides for distribution to the children on the death of the community spouse, then these assets, in most states, would be subject to the elective share provisions. The surviving Medicaid recipient would, therefore, have an obligation to assert his or her right to the elective share against the trust assets. Failure to do so would constitute a transfer for Medicaid eligibility purposes. Four recent cases are on point.

In the first case the institutionalized spouse entered a nursing home. The community spouse died first. Under the terms of the will of the community spouse a special needs trust was established for the benefit of the institutionalized spouse to satisfy the elective share. The County Welfare Board refused to grant Medicaid believing that the assets in the trust were available. The Administrative Law Judge applied the New Jersey "trust buster statute," *N.J.S.A. 30:4D-6(f)*, and concluded that the assets in the trust were available. Under appeal the Director affirmed the decision of the ALJ but did not apply the "trust buster statute," instead holding that the trust in question was a Medicaid qualifying trust. Petitioner appealed to the Appellate Division of the Superior Court on grounds that the Medicaid qualifying trust statute had been repealed two years prior to death of the community spouse. The case was eventually settled. *See A.H. v. DMAHS*, No. A-559-00T3 (N.J. Super. App. Div. 2003).

In a second case the institutionalized spouse entered a nursing home. Again, the community spouse had a will establishing a special needs trust for the benefit of the institutionalized spouse. The community spouse committed suicide. Medicaid was denied by the County Board of Social Services. The ALJ held that the resources were not transferred to the testamentary trust for purposes of creating Medicaid eligibility and, therefore, the trust is an excludable resource. The Director modified the decision holding that to the extent the trust assets consisted of the Community Spouse Resource Allowance and the residence, the assets were unavailable. *See E.O. v. DMAHS*, OAL Dkt. No. HMA-2858-00.

A third case involved a situation wherein the institutionalized spouse was not institutionalized until after the community spouse's death. Again, the will of the community spouse

established a special needs trust for the benefit of the institutionalized spouse. The Director held that since the institutionalized spouse did not enter a nursing home until after the death of the community spouse, there was no transfer penalty. The issue of availability was not raised. The Director further opined that in the future failure to exercise the spousal right of election would result in the imposition of a transfer penalty. *See S.N. v. DMAHS*, OAL Dkt. No. HMA-3518-00.

In the fourth case, the community spouse established a discretionary support trust for the benefit of the institutionalized spouse to satisfy the elective share. The trust language was, “In addition, the Trustee may pay to or apply for the benefit of my Wife the principal of the trust from time to time in such amounts as my Trustee in its uncontrolled discretion deems necessary for my Wife’s comfortable maintenance, support, health and well-being.” The ALJ held that since the institutionalized spouse had no right to compel distribution from the trust the assets were unavailable. The Director commented that if assets are given away within 36 months from the date of application for less than fair market value, a transfer penalty would be imposed. The case was remanded for additional evidence. *See K.F. v. DMAHS*, OAL Dkt. No. HMA-4184-00.

g. Tax Consequences

i) Income Tax

If the trust is structured as a grantor trust, the income tax is paid by the grantor at the grantor’s tax rates, rather than by the trust at the compressed trust tax rates. I.R.C. § 6779(a).

ii) Capital Gains Exclusion for Sale of Principal Residence

By transferring a residence to an income only trust in which the grantor retains the right to substitute and reacquire property, the exclusion from capital gains on the sale of a principal residence can be maintained.

iii) Gift Tax

An income only trust can be designed in such a way that a transfer into a trust may or may not be a gift. If the grantor desires that the transfer be considered a gift for tax purposes, a gift tax return would be filed based on the present value of the gift. This would be the value of the assets transferred, less the value of the grantor’s retained interest in the income stream.

If the grantor wants to avoid having the transfer treated as a gift, the trust can be designed so that the grantor retains a limited power of appointment in the trust corpus. The limited power of appointment would enable the grantor to appoint the remainder of the trust to a limited class of people. The limited power of appointment could either be testamentary or *inter vivos*. In that case, a gift tax return would not be required.

iv) Estate Tax

Since the grantor reserved the right to income, the entire value of the estate would be included in the grantor's estate for federal estate tax purposes. I.R.C. § 1014, 2036, 2038; Treas. Reg. §§ 1.1014-2(a)(3), (b).

Because the assets are included in the estate of the grantor, the estate should receive a step up in the tax cost basis of trust assets to the fair market value of the assets as of the grantor's death. It is not completely clear that this is the case, so a strategy to guarantee the step up and achieve the benefit of the trust is to transfer a remainder interest in the residence to the trust and retain a life estate in the grantor. In many cases, this is a significant advantage over outright transfers to children.

h. Transfers to Trusts versus to Individuals

ISSUE	INCOME ONLY TRUST	INDIVIDUALS
Lookback	Five Years	Five Years
Control	Some	None
Risk Avoidance	Yes	No
Financial Aid	Yes	No
Estate Recovery	Maybe	No
Income Tax	Parent	Children
Gift Tax	Maybe	Yes
Step Up in Basis	Yes	No
Principal Residence Exclusion	Yes	No

7. Children's Trust

In order to protect against the state's claim that a distribution of its principal constitutes a transfer of income to the beneficiary, a children's trust can be designed. The children's trust would work much the same as the income only trust, except that the parent would have no right to income. Both income and principal could be distributed only to children. The trust would receive the same benefit with respect to having the trust assets insulated from the risk factors discussed above under income only trust and could achieve the same tax benefits as the income only trust, except that the income would have to be taxed either to the trust or distributed to the children and taxed to them.

8. Donee Trust

A useful vehicle in Medicaid planning may be a donee trust. Under this arrangement the parent would transfer assets to the children, who would then establish a trust. Since the trust is a self-settled trust, it would not be immune from claims of the children's creditors, nor would it receive any of the tax benefits, such as utilizing the § 121 exclusion from capital gains tax on the sale of a principal residence or the step-up on basis on appreciated assets. Under the donee trust, the parents would retain no interest in the trust. The children could give the parents an income interest, if so desired. One of the advantages of this trust would be to consolidate all of the transferred assets into one account for better investment management.