USING TRUSTS IN MEDICAID AND VETERAN'S ASSET PROTECTION PLANNING

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Note: This outline is intended to educate and assist readers, but does not constitute legal advice. Readers should consider carefully the applicability and consequences of using any planning technique. The writer and publisher expressly disclaim (i) all warranties, express and implied, including, without limitation, of merchantability and fitness for any particular purpose, and (ii) all other responsibility for all consequences of use of this material.

Note: Trust excerpts contained herein do not contain all of the provisions that the author uses for particular clients; all trusts must be customized to meet the specific needs of individual clients.

ABOUT THE AUTHOR

Evan Farr is the creator of the **Living Trust Plus™ Asset Protection System** used by dozens of Estate Planing and Elder Law Attorneys around the country, and is widely recognized as one of the foremost experts in the Country in the field of Medicaid Asset Protection and related Trusts. Evan has been quoted or cited as an expert by numerous sources, including the *Washington Post*, *Newsweek Magazine*, *Northern Virginia Magazine, Trusts & Estates Magazine, The American Institute of Certified Public Accountants*, and the American Bar Association, and has been featured as a guest speaker on numerous radio shows, including WTOP and Washington Post Radio.

Evan has been named by SuperLawyers.com as one of the top 5% of Elder Law and Estate Planning attorneys in Virginia every year since 2007, and in the Washington, DC Metro Area every year since 2008. In 2011, Evan was named by Washingtonian Magazine as one of the top attorneys in the DC Metropolitan area, by Northern Virginia Magazine as one of the top attorneys in the Northern Virginia area, and by Newsweek Magazine as one of the top attorneys in the country.

AV-Rated by Martindale-Hubbell, Evan is a nationally renowned Best-Selling author and frequent educator of attorneys across the U.S. As an expert to the experts, Evan has educated tens of thousands of attorneys across the country through speaking and writing for organizations such as his own Elder Law Institute for Training and Education (ELITE), the National Academy of Elder Law Attorneys (NAELA), the American Law Institute-American Bar Association (ALI-ABA), the National Business Institute (NBI), the Virginia Academy of Elder Law Attorneys (VAELA), the Virginia Bar Association (VBA), Virginia Continuing Legal Education (Virginia CLE) , and the District of Columbia Bar Association. His publications include a Best-Selling book, *Protect and Defend*, as well as *The Virginia Nursing Home Survival Guide*, numerous articles that have appeared in the popular press, and numerous scholarly publications for the legal profession, including two legal treatises published by and available through ALI-ABA: *Planning and Defending Asset Protection Trusts* and *Trusts for Senior Citizens*.

SECTION 1. TRUSTS FOR MEDICAID ASSET PROTECTION PLANNING

1.1. Irrevocable Income-Only Asset Protection Trusts.

1.1.1. General Considerations.

1.1.1.1. There is little reason for middle class Americans desiring to create an asset protection trust to go outside of their home state. Residents of most states may create an irrevocable, income-only trust (IOT) to protect their assets. With an IOT, the Settlor retains the right to receive the trust income, but does not retain the right to access the principal of the trust. Principal can be retained in the trust or paid to beneficiaries other than the settlor or the settlor's spouse. After the Settlor's death, an IOT may terminate or may continue with income payable to the settlor's spouse and principal distributed to or held in further trust for the benefit of the remainder beneficiaries, typically the settlor's children.

1.1.1.2. For middle class Americans, the IOT is the preferable form of asset protection trust because, for purposes of Medicaid eligibility, the IOT is the **only** type of self-settled asset protection trust that allows a Settlor to retain an interest in the trust while also protecting the assets from being counted by state Medicaid agencies. For Medicaid eligibility purposes, if the Settlor has any access to the principal of a trust,[1] then the entire principal balance of the trust is a countable resource.[2]

1.1.1.3. The Settlor of an IOT can serve as the Trustee,[3] which is an important consideration for many persons wanting to establish an asset protection trust.

1.1.2. Practical Considerations.

1.1.2.1. Middle class Americans seeking asset protection can not afford to ignore the potentially devastating costs of nursing home care and other long-term care. On the contrary, nursing homes are the most likely and one of the most expensive creditors that the average American is likely to face in his or her lifetime. Consider the following statistics:

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[1] As is the case with so-called "Offshore Asset Protection Trusts" (discussed *infra*, section?) and "Domestic Asset Protection Trusts" (discussed *infra*, section?).

[2] *See infra*, section 1.2.3.

[3] *See supra* section 1.4.1, 1.4.3, 2.9.1, 2.9.2.

1.1.2.1.1. About 70% of Americans who live to age 65 will need long-term care at some time in their lives,[4] over 40 percent in a nursing home.[5]

1.1.2.1.2. As of 2008, the national average cost of a private room in a nursing home was $212 per day or $77,380 per year, and the national average cost of a semi-private room was $191 per day or $69,715 per year.[6]

1.1.2.1.3. On average, someone age 65 today will need some long-term care services for three years. Women need care for longer (on average 3.7 years) than do men (on average 2.2 years). While about one-third of today's 65-year-olds may never need long-term care services, 20 percent of them will need care for more than five years.[7]

1.1.2.1.4. Also, long-term care is not just needed by the elderly. A study by Unum, released in November, 2008, found that 46 percent of its group long-term care claimants were under the age of 65 at the time of disability.[8]

1.1.2.2. Contrast the above long-term care statistics with statistics for automobile accident claims and homeowner's insurance claims:

1.1.2.2.1. Between 2005 and 2007, an average of only 7.2% of people per year filed an automobile insurance claim.[9]

1.1.2.2.2. Between 2002 and 2006, an average of only 6.15% of people per year filed a claim on their homeowner's insurance.[10]

1.2. Using Income-Only Trusts for Medicaid Asset Protection.

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[4] *Americans Fail to Act on Long Term Care Protection*, American Society on Aging, May 2003. National Clearinghouse for Long-Term Care Information, http://www.longtermcare.gov at http://www.longtermcare.gov/LTC/Main_Site/Understanding_Long_Term_Care/Basics/Basics.aspx#needs.

[5] National Clearinghouse for Long-Term Care Information, http://www.longtermcare.gov at http://www.longtermcare.gov/LTC/Main_Site/Understanding_Long_Term_Care/Basics/Basics.aspx#needs.

[6] The MetLife Market Survey of Nursing Home & Assisted Living Costs, October 2008.

[7] National Clearinghouse for Long-Term Care Information, http://www.longtermcare.gov at http://www.longtermcare.gov/LTC/Main_Site/Understanding_Long_Term_Care/Basics/Basics.aspx#needs.

[8] Insurance Information Institute, http://www.iii.org/media/facts/statsbyissue/longtermcare.

[9] Insurance Institute for Highway Safety, http://www.iii.org/media/facts/statsbyissue/auto, based on data from the Highway Loss Data Institute.

[10] Insurance Institute for Highway Safety, http://www.iii.org/media/facts/statsbyissue/homeowners, based on data from the Insurance Services Office.

1.2.1. Basic Overview of Medicaid Asset Protection Planning.

1.2.1.1. **Introduction.** A detailed understanding of Medicaid rules and Medicaid Asset Protection strategies is beyond the scope of this book.[11] However, a very basic understanding of the Medicaid lookback period and transfer penalty rules is essential to an understanding of the use of and importance of the IOT.

1.2.1.2. **Lookback Period.** For Medicaid eligibility purposes, since February 8, 2006, there has been a 5-year lookback period for uncompensated transfers.[12] This means that on an application for Medicaid benefits, there is a question which asks if the applicant or the applicant's spouse has made any uncompensated transfers made to an individual or to a trust within the previous 5 years. All such transfers must be disclosed to Medicaid, and failure to do so constitutes Medicaid Fraud, which is a criminal offense.

1.2.1.3. **Transfer Penalty.** Any uncompensated transfer of assets made within the 5-year lookback period results in a penalty period, which is a period of ineligibility for Medicaid long-term care. The period of ineligibility does not begin when the transfer is made, but rather when the person enters the nursing facility, applies for Medicaid, is "otherwise eligible" for Medicaid, meaning the person has countable assets of less than the minimum resource allowance ($2,000 in most states) and is medically in need of nursing home care. The penalty period is calculated by dividing the amount of the transfer by an amount called the "penalty divisor," which differs from state to state. The penalty period resulting from an uncompensated transfer can be longer than 5 years.

1.2.1.4. **Example 1.** Joe transfers $500,000 to an IOT (or to his children) in January of 2009, and then enters a nursing home and applies for Medicaid in December of 2014. The penalty divisor for Joe's state is $5,000. Joe is eligible for Medicaid but for the uncompensated transfer. By applying for Medicaid before the expiration of the 5-year lookback period, Joe must report the $500,000 uncompensated transfer, which results in a 100-month penalty period, so Joe is not eligible for Medicaid long-term care until April, 2023.

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[11] For a comprehensive treatise on Medicaid Asset Protection, including the use of income-only trusts, see Begley, Jr. & Hook, *Representing the Elderly or Disabled Client: Forms and Checklists with Commentary* ¶ 7.02 (WG&L 2007).

[12] Prior to the enactment of the federal Deficit Reduction Act ("DRA"), Pub. L. No. 109-171 (2/8/2006), the lookback period was three years for outright transfers and 5 years for transfers to trust. This disparity in the treatment of transfers made pre-DRA transfers into irrevocable trusts much less attractive than they are now. For a good explanation of the background and history of income-only trusts, *see* Shirley B. Whitenack, Gary Mazart, and Regina M. Spielberg, *The Revival of the Income-Only Trust in Medicaid Planning*, Estate Planning J. (WG&L January 2009).

1.2.1.5. **Example 2.** Same facts except Joe waits to apply for Medicaid until March of 2015. By applying for Medicaid after the expiration of the 5-year lookback period, Joe does not have to report the $500,000 uncompensated transfer, meaning there is no penalty period and Joe is eligible for Medicaid in the month of application.

1.2.2. Purpose of Using Income-Only Trusts for Medicaid.

1.2.2.1. **Asset Protection**. IOTs are a means by which clients can transfer assets they wish to protect to a trust rather than directly to their children. Clients rightfully view transfers to trusts as protection, whereas transfers to adult children are typically viewed as gifts. Trusts provide clients with a sense of dignity and security.[13] Such transfers, whether to an IOT or directly to a child, are subject to the Medicaid five-year lookback period.[14]

1.2.2.2. **Independence**. By transferring assets to an IOT, income is paid directly to the trust settlor rather than to her children, allowing the settlor to maintain greater financial independence. When real estate is transferred to an IOT, the trust is written so that the Settlor retains the ability to live in the real estate or receive the rental income from the property.

1.2.2.3. **Risk-Avoidance**. If a parent transfers assets directly to his children, certain risks must be anticipated: creditors claims against a child; divorce of a child; bad habits of a child; need for financial aid; loss of step-up in basis.

1.2.2.3.1. A transfer to an IOT avoids all of these risks.[15]

1.2.3. Statutory Authorization.

1.2.3.1. Income-only trusts, which must be irrevocable, have been permitted under federal Medicaid law since OBRA '93,[16] which states:

> "In the case of an irrevocable trust . . . if there are any circumstances under which payment from the trust could be made to or for the benefit of the individual, the portion of the corpus from which, or the income on the corpus from which, payment

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[13] Begley, Jr. & Hook, *Representing the Elderly or Disabled Client: Forms and Checklists with Commentary* ¶ 7.02 (WG&L 2007).

[14] *See supra*, section 1.2.1.2.

[15] *See infra,* section 1.6.7, for an explanation of why a transfer to an IOT avoids the loss of step-up in basis.

[16] 42 U.S.C. § 1396p(d)(3)(B).

to the individual could be made shall be considered resources available to the individual."

1.2.3.2. Under OBRA '93, an individual is considered to have established a trust if the individual's assets were used to fund all or part of a trust and if the trust was established, other than by will,[17] by any of the following: the individual, the individual's spouse, a person (including a court or administrative body) with legal authority to act on behalf of the individual or the individual's spouse, or a person (including a court or administrative body) acting at the direction or request of the individual or the individual's spouse.[18]

1.2.3.3. Income-only trusts are also permitted under the CMS State Medicaid Manual, which states that:

> "In the case of an irrevocable trust, where there are any circumstances under which payment can be made to or for the benefit of the individual from all or a portion of the trust . . . [t]he portion of the corpus that could be paid to or for the benefit of the individual is treated as a resource available to the individual."[19]

1.2.4. Principal Distribution Provision.

1.2.4.1. There can be absolutely no access to principal by either the settlor or the settlor's spouse. If either spouse has direct access to principal, the trust is not an income-only trust, and the assets in the trust would be available to creditors and deemed "countable" for Medicaid eligibility purposes.[20]

> **Practice Tip:**
> Be sure not to allow any access to principal by either the settlor or the settlor's spouse.

[17] The creation and funding of a testamentary trust is not a disqualifying transfer of assets. *See Skindzier v. Comm'r of Soc. Servs.*, 784 A2d 323 (Conn. 2001) .

[18] 42 USCA § 1396p(d)(2).

[19] CMS State Medicaid Manual, Section 3259.6.B.

[20] Begley, Jr. & Hook, *supra* § 7.02[7][b].

1.2.4.2. The trust should be designed to permit the trustee, or a third party, to make distributions to beneficiaries. Through this mechanism, the trustee can stop income payments to a settlor who will be requiring Medicaid and can avoid estate recovery in those states that use a broad definition of "estate."[21] Through this mechanism, the beneficiaries could also, if they choose, make distributions of principal back to the Settlor or for the benefit of the Settlor.

Practice Tip:
Provide a safety valve allowing distributions of corpus to children or other beneficiaries who might be willing to return the money to the Settlor or pay for the elder's care if and when needed, but be sure to avoid any collusion or advance agreements between settlors and beneficiaries.

1.2.4.2.1. The disadvantage of distributing the assets from the income-only trust is that the opportunity for a "step- up" in basis will be lost.[22]

1.2.4.2.2. It is important, of course, that there be no collusion between the Settlor and the trust beneficiaries whereby the trust beneficiaries agree in advance to make principal distributions back to the Settlor or for the benefit of the Settlor.

1.2.4.3. Care must be taken in considering whether to authorize a trustee who is not the settlor to make distributions of trust principal to himself. Authorization of such distributions would be considered a general power of appointment held by the trustee, and if the trustee predeceases the settlor, the value of the trust assets could be included in the estate of the trustee for estate tax purposes.[23] This can be avoided by requiring a trust protector or independent trustee to acquiesce in any transfers to the trustee.

Practice Tip:
Avoid unexpected estate inclusion by requiring a trust protector or independent trustee to acquiesce in any transfers to the trustee.

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[21] *See supra*, section 1.2.8.

[22] Begley, Jr. & Hook, *supra* § 7.02[7][c].

[23] Begley, Jr. & Hook, *supra* § 7.02[7][c].

1.2.5. Cases Illustrating Prohibition of Retained Interest in Corpus.

1.2.5.1. A trust in which the Settlor or the Settlor's spouse retains an interest in the principal is not an IOT. The following cases illustrate this point:[24]

> **Practice Tip:**
> Never allow a Settlor of an income-only trust, or the spouse of the Settlor, to retain any interest in the trust corpus.

1.2.5.1.1. In both *United States v. Ritter United States v. Ritter*, 558 F.2d 1165, 1167 (4th Cir. 1977), and *Petty v. Moores Brook Sanitarium*, 110 Va. 815 (1910), the trust Settlor retained the right to have the trust corpus returned to the Settlor in the discretion of the Trustee. This retained power to return of the corpus was clearly a significant factor for both courts in concluding that the trust assets were not protected from the creditor of the Settlor.

1.2.5.1.2. *In Re Robbins*, 826 F.2d 293 (4th Cir. 1987) is a case arising in Maryland that was decided on the basis of the settlor's retained interest in the corpus of the trust. The Fourth Circuit held that under the terms of the trust, the trustee was authorized to apply the entire corpus for the support and maintenance of the settlors, and thus the entire corpus was subject to the claim of their creditors. *Id.* at 294.

1.2.5.1.3. In the Pennsylvania case of *In re Nolan*, 218 Pa. 135, 67 A. 52 (1907), the settlor retained the power to appoint the remainder and the trustee had the power to reconvey the property to the settlor. The Court held that no creditor protection was available.

1.2.5.1.4. In *Gayan v. Illinois Dept. of Human Services,* Ill. App. Ct., No. 3-02-0545 (Aug. 29, 2003), an irrevocable trust that allowed the trustee to distribute principal to pay for costs of custodial care not covered by Medicaid was found to be an available asset, the settlor's intent notwithstanding.

1.2.5.1.5. In *Balanda v. Ohio Dept of Job and Family Services,* 2008-Ohio-1946 (April 24, 2008), an Ohio appeals court ruled that assets held in an irrevocable trust were available to a Medicaid applicant because the trustee had the discretion to make payments of trust principal for the benefit of the applicant and the applicant's spouse.

1.2.5.1.6. In *Wisynski v. Wis. D.O.H. & Family Serv.,* Wis. App., Dist. 3, No. 2008AP1280 (Nov. 4, 2008), the irrevocable trust inovolved does not appear to have been written as an income-only trust, but the opinion is not clear on that issue, as it

[24] Many of the cases cited in this section have been erroneously categorized by some commentators as income-only trusts, and therefore relied on to attempt to demonstrate that income-only trusts are not effective asset protection entities; however, as explained herein, none of the cases cited in this section were income-only trusts, as they all contained provisions allowing distribution of principal to the trust settlors.

does not give any information about the trust other than to say that the Medicaid applicant named himself as a "beneficiary." The opinion does not explain whether the applicant named himself as a beneficiary of income, principal, or both. The use of the term "beneficiary" without further limiting the language would imply that the applicant was a beneficiary of both income and principal, properly resulting in the trust principal being found to be available.

1.2.5.1.7. *Clifford and Ruth Oyloe v. North Dakota Department of Human Services*, 2008 ND 67; 747 N.W.2d 106; N.D. LEXIS 66 (April 17, 2008). This case, from the Supreme Court of North Dakota, involved a claim by the State Medicaid Agency ("Agency") that the assets of the applicant's irrevocable trust were countable for purposes of Medicaid.

1.2.5.1.7.1. The Agency challenged the trust the grounds of a drafting error involving the proceeds that were paid into the trust after the sale of real estate. The trust gave the trustee discretion to sell the Oyloes' home and distribute the proceeds if the Oyloes no longer resided there. Paragraph 2(b) of the trust provided:

> "During the joint lifetime of the Grantors, if there ever comes a time when neither of the Grantors is living in the personal residence of the Grantors transferred into trust and it is unlikely to ever be occupied by them again, the Trustee has the option to sell said personal residence and immediately distribute the proceeds from the sale in accordance with the terms of paragraph 1.(d) of this Agreement, subject only to the requirements of paragraph 4."

1.2.5.1.7.2. The crucial drafting error was that the trust agreement did not contain a paragraph 1.(d). Accordingly, the Court found the the sales proceeds from the house could possibly be given back to the Grantor, meaning that the trust was actually not an income-only trust, but rather one that allowed principal distributions to the Grantor.

1.2.5.1.7.3. Importantly, the Agency did not take the position that the other trust assets were countable assets for Medicaid purposes.

1.2.5.1.8. *Boruch v. Nebraska Dept. Of Health & Human Servs.*, 11 Neb. App. 713, 659 N.W.2d 848 (2003). This case, from the Nebraska Court of Appeals, involved the appeal of a Medicaid applicant ("Lambert Boruch") of a determination by the State Medicaid Agency ("Agency") that the assets of Boruch's irrevocable trust were countable for purposes of Medicaid. According to the Court, "Lambert [Boruch] was the grantor and *beneficiary of the corpus* of the Trust, and his son, Ronald, was a co-successor trustee." The Court goes on to explain that "[t]he Trust was established as an irrevocable instrument and provided that the beneficiary, Lambert, was entitled to the use and possession of the real property, as well as the annual net income derived therefrom, for his lifetime." *Id.* at 714 (emphasis added). Clearly, this trust

was not designed as an IOT, as the Court indicated that Boruch was the beneficiary of the corpus of the Trust, which is a feature that is absolutely prohibited in a properly-structured IOT.

1.2.5.1.9. Although there is a disturbing interpretation of the law in *Boruch* (stating that "if an individual establishes an irrevocable trust with his or her funds and is the beneficiary of or can benefit from the trust under any circumstances, the trust corpus is counted in the determination of Medicaid eligibility" *Id.* at 719), this interpretation of federal Medicaid law[25] is entirely abberational and is not supported by the law. In any event, this abberational finding can arguably be considered dicta in that the trust in question was clearly not structured as an IOT.

1.2.5.1.9.1. The Court also indicated that the Medicaid applicant in Boruch was the "sole beneficiary" of the trust (*Id.* at 720), presumably meaning that there were no remainder beneficiaries of the trust, and in fact the Court's opinion gives no indication of any remainder beneficiaries named in the trust. An important feature of a properly-drafted IOT is that the corpus of the trust is immediately vested in the remainder beneficiaries (who therefore have the right to enforce the terms of the trust), while only the income interest is retained by the Settlor. Even if the trust in *Boruch* had been drafted as an IOT with the Settlor ostensibly retaining no interest in the corpus, without any remainder beneficiaries there is no one to enforce the terms of the trust, and the trust is therefore analogous to a revocable trust whose assets are completely available for the purposes of Medicaid. Although this rationale was not articulated by the Court in in *Boruch,* it is possible that this might have had an affect on the Court's decision.

1.2.6. Income Distribution Provisions.

Practice Tip:
Allow only "ordinary income" to be distributed to the settlor or the settlor's spouse.

1.2.6.1. Although neither the settlor nor the settlor's spouse can receive distributions of principal, they can receive discretionary or mandatory distributions of trust income. In this writer's opinion, "income" means interest, ordinary dividends,[26] rental income, royalties, and any other taxable income that does not qualify for capital gains treatment. The reason for excluding income from capital gains is that historically capital gains have been considered to be part of principal, and trustees were required to distribute only income to the

[25] 42 USC § 1396p(d)(3)(B).

[26] Perhaps also "qualified dividends," but *see* n.20 for a futher discussion of allowable distributions of income..

income beneficiaries, retaining the principal and all capital gains realized by the trust for the ultimate benefit of the trust's remainder beneficiaries.[27]

1.2.6.2. This view of what constitutes "income" for purposes of an income-only trust is this writer's opinion based upon an abudance (perhaps an over-abundance) of caution developed over years of dealing with Medicaid officials. Most commentators do not distinguish between different types of income in the context of an income-only trust, and some drafters of income-only trusts will treat certain distributions of capital gains as income distributions. Unfortunately, this is a very complex area made even more difficult by the fact that the definition of income for tax purposes is different from the definition of income for Medicaid purposes, and complicated further because the Federal Medicaid law, OBRA '93,[28] does not directly define the term "corpus" in the context of income-only trusts.

1.2.6.3. The IRS defination of income in the context of trusts states that the term "*income*, when not preceded by the words *taxable*, *distributable net*, *undistributed net*, or *gross*, means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law." It further explains that "items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal."[29]

1.2.6.4. The relevant Federal Medicaid law, OBRA '93,[30] states that the term "income" has the meaning given such term in 42 U.S.C. § 1382a, which in turn states, in the context of trusts, that income includes: "any earnings of, and additions to, the corpus of a trust established by an individual . . . and, in the case of an irrevocable trust, with respect to which circumstances exist under which a payment from the earnings or additions could be made to or for the benefit of the individual." [31] Although OBRA '93 does not define the term "corpus," because it incorporates the definition of "income" from § 1382a and because § 1382a uses the term "corpus," presumably one must look to § 1382a for the appropriate definition of "corpus." The term "corpus" as defined therein means "with respect to a trust, all property and other interests held by the trust, including accumulated earnings and any other

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[27] *See* Barbara A. Sloan, T. Randolph Harris, and George L. Cushing, *When Income Isn't 'Income'—The Impact of the New Proposed Regulations Under Section 643*, Journal of Taxation (WG&L June 2001).

[28] 42 U.S.C. § 1396p(e)(2).

[29] Treas. Reg. § 1.643(b)-1.

[30] 42 U.S.C. § 1396p(e)(2).

[31] 42 U.S.C. § 1382a(a)(2)(G).

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)." [32]

1.2.7. Adjustments Between Principal and Income.

1.2.7.1. This writer believes that the trustee must be affirmatively prohibited from exercising any powers to adjust between income and principal, regardless of whether such powers are granted by common law or statute or both:

> **Practice Tip:**
> Consider carefully whether to allow the trustee to treat capital gains as income, and be sure to prohibit the trustee from adjusting between income and principal or converting to a unitrust.

1.2.7.1.1. The Trustee must not have the power adjust between income and principal.

1.2.7.1.2. The Trustee must not have the power to convert thetrust to a total return unitrust.

1.2.8. Medicaid Estate Recovery.

1.2.8.1. Federal law requires states to institute programs to recover nursing home and long-term care Medicaid expenses paid after 10/1/93, from the estates of deceased Medicaid beneficiaries.[33] Whether estate recovery applies to assets held in an income-only trust depends, in part, on whether a state uses the narrow, "probate" definition of "estate" or a broad definition of "estate" that includes a living trust.[34]

1.2.8.2. At least 30 states use the narrow probate definition of estate in their Medicaid recovery program, while at least 14 states use an expanded definition of estate in their Medicaid recovery programs to include both probate and nonprobate assets.[35]

1.2.8.3. In a situation involving an unmarried person, if the assets were transferred by the

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[32] 42 U.S.C. § 1382b.

[33] 42 U.S.C. §1396p(b). Pursuant to 42 U.S.C. §1396p(b)(2)(A), estate recovery may be made only after the death of the Medicaid recipient's spouse and may not be made if there is a surviving child who is a minor or who is disabled or blind.

[34] Begley, Jr. & Hook, *supra* at § 7.02[4].

[35] *See* Oppenheim and Moschella, *National Perspective on Expanded Estate Recovery: Case Law Analysis, Emerging Legislative Trends and Responsive Strategies for the Elder Law Attorney*, 1 NAELA J. 7 (Spring 2005).

Medicaid recipient to an income-only trust for the benefit of the Medicaid recipient, the Medicaid recipient subsequently died, and the state had a narrow definition of "estate," the assets in the trust would not be subject to estate recovery. Given the same facts in a state with a broad definition of "estate," the assets in the trust may be subject to estate recovery. An argument could be made that the estate recovery statute applies only if there is a living trust in which the Medicaid recipient had a "legal interest" at the time of death. Because the beneficiary of a trust has an equitable interest rather than a legal interest, an argument can be made that the assets in the trust are not subject to estate recovery. A more conservative approach would be that the assets in the trust are subject to estate recovery in those states that use a broad definition of "estate."[36]

1.2.8.4. An income-only trust established for the benefit of the spouse of a Medicaid recipient, in which a Medicaid recipient holds no legal interest at the time of his or her death, should not be subject to estate recovery.[37]

1.2.8.5. However, some states with expanded definitions of estate recovery will seek estate recovery against the estate of the spouse of the Medicaid recipient against assets in which the Medicaid recipient holds no legal interest at the time of his or her death.[38]

1.2.8.6. As discussed earlier, an IOT should be designed to permit the trustee, or a third party, to make distributions to beneficiaries. Through this mechanism, the trustee can stop income payments to a settlor who will be requiring Medicaid and can avoid estate recovery in those states that use a broad definition of "estate." Such distribution of assets and termination of income payments might be considered an uncompensated transfer (of the right to receive future income payments) if the Medicaid applicant participates in such termination (*e.g.*, if the Medicaid applicant is acting as trustee or co-trustee at the time of such distribution), but should not be treated as an uncompensated transfer so long as the Medicaid applicant is not involved in such distribution.

1.2.8.7. Nevertheless, a distribution of principal which terminates income was considered an uncompensated transfer of the right to receive future income payments (even though the Medicaid applicant was not the trustee) in a New Jersey case reported

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[36] Begley, Jr. & Hook, *supra* at § 7.02[4].

[37] *See* Shirley B. Whitenack, Gary Mazart, and Regina M. Spielberg, *The Revival of the Income-Only Trust in Medicaid Planning*, Estate Planning J. (WG&L January 2009).

[38] *See* Whitenack, Mazart, and Spielberg, *The Revival of the Income-Only Trust in Medicaid Planning*, *supra*., for a review of cases allowing expanded estate recovery from a trust.

by Whitenack, Mazart, and Spielberg.[39] In that case, the Medicaid applicant was the grantor of an IOT. Prior to submitting a Medicaid application, the grantor's son/trustee terminated the trust and retained the assets. Medicaid argued that the entire principal of the trust, as well as the income generated, should be counted as available resources. The final agency decision found that the transfer of assets took place when the applicant/grantor gave up his right to principal and transferred the assets to the trust, and found that the trust termination created an additional transfer of the income right that triggered a penalty period of Medicaid ineligibility and was valued based on the life expectancy of the applicant/grantor.[40]

1.3. Can an Income-Only Trust be Revoked?

1.3.1. Definition of *Irrevocable*.

1.3.1.1. Although an IOT is, by definition, irrevocable, it is important to understand that an "irrevocable" trust is simply a trust that can not be revoked unilaterally by the Settlor. Under common law and under the Uniform Trust Code,[41] the term "revocable," as applied to a trust, means revocable by the settlor without the consent of the trustee or a person holding an adverse interest.

1.3.1.2. Uniform Trust Code has been enacted in 21 jurisdictions.[42]

1.3.2. Revocation by Consent.

1.3.2.1. Under the common law and the statutes of many states, including under Section 411 of the Uniform Trust Code, a non-charitable irrevocable trust can be revoked upon consent of the settlor and all trust beneficiaries.[43]

Practice Tip:
Be sure to avoid collusion between the Settlor and the trust beneficiaries whereby the trust beneficiaries agree in advance that they will revoke the trust for the benefit of the Settlor.

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[39] *J.S. v. Division of Medical Assistance and Health Services,* Docket No. HMA-4896-06. Final Agency Decision (3/22/07).

[40] *See* Whitenack, Mazart, and Spielberg, *The Revival of the Income-Only Trust in Medicaid Planning*, *supra*.

[41] Uniform Trust Code, Section 103 (Definitions).

[42] *See infra*, section 1.5.2.1.1.

[43] *See* Ian Marsh and Michael Ben-Jacob*, Irrevocable Trusts Can (Sometimes) Be Revoked,* Trusts and Estates Magazine (WG&L May 1, 2004).

1.3.2.2. Accordingly, in most states an IOT can be revoked, and the assets returned to the Settlor, if the Settlor and all trust beneficiaries agree to the revocation.

1.3.2.2.1. It is important, of course, that there be no collusion between the Settlor and the trust beneficiaries whereby the trust beneficiaries agree in advance that they will revoke the trust for the benefit of the Settlor.

1.4. Trustee Considerations.

1.4.1. Can Settlor Serve as Trustee?

> **Practice Tip:**
> Consider allowing the Settlor of the income-only trust to act as Trustee.

1.4.1.1. The most common question asked by clients wanting to establish an IOT is whether they, as the Settlor of the trust, can also act as the trustee of the trust.

1.4.1.2. Although many commentators and attorneys in private practice take the position that a Settlor can not serve as the Trustee of an irrevocable trust established by the Settlor, this author has seen no legal support for this conclusion in connection with an IOT. This author and many other elder law attorneys in private practice[44] take the position that the Settlor can serve as the Trustee of an income-only trust.

1.4.2. Trustee is a Fiduciary.

1.4.2.1. It is basic hornbook trust law that a trustee stands in a fiduciary position with reference to the trust assets and cannot derive personal benefit from acting as trustee.[45] The trustee's creditors therefore have no claim to the trust assets to satisfy personal claims of the trustee. Clearly creditors can reach the income interest retained by the Settlor, but creditors should not be able to reach the remainder interest in the trust because that interest is irrevocably vested in the remainder beneficiaries and the Settlor has no ownership over the vested remainder.

1.4.2.2. This immediate vesting in the remainder beneficiaries is an important feature of a properly-drafted IOT, because without immediate vesting in remainder beneficiaries no one wouold have the the right to enforce the terms of the trust,

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[44] *See* Todd E. Lutsky, *Medicaid Income Only Trusts Prevail Against Expanded Estate Recovery Rules*, http://www.elderlawcenters.com/CM/Articles/Medicaid_Income_Only_Trusts.pdf; *see also* K. Gabriel Heiser, *How to Protect Your Family's Assets from Devastating Nursing Home Costs* (2007).

[45] *See, e.g.,* Rev Rul 77-285, 1977-2 CB 213 (the trust instrument in question provided that the grantor could remove the trustee for any reason and substitute any other person – including the grantor – as trustee; held that even if the grantor becomes trustee, there would be nothing he could do to alter the amounts paid to recipients).

which would render the trust analagous to a revocable trust and would therefore provide no asset protection to the Settlor.

1.4.3. Settlor Can Remove and Replace Trustee.

1.4.3.1. Just as a settlor can serve as the trustee of his own IOT, so can the settlor retain the right to remove and replace someone else acting as trustee of the settlor's IOT. The exact same logic applies.

1.4.4. Source of Confusion.

1.4.4.1. It is this author's belief that the reason many attorneys avoid naming the Settlor as a Trustee of an irrevocable trust is because many attorneys are most familiar with using irrevocable trusts to hold life insurance, where the tax goal is to structure the trust so that the transfer to the trust is a completed gift so that the insurance proceeds are not brought into the Settlor's estate pursuant to IRC § 2042.[46]

> **Practice Tip:**
> Consider giving the Settlor of the income-only trust the right to remove and replace Trustees.

1.4.4.2. Attorneys drafting irrevocable life insurance trusts typically do not allow the Settlor to serve as the Trustee, based on the lingering fear that serving as trustee will be deemed by the IRS to constitute "incidents of ownership" over the life insurance policy, thereby bring the policy proceeds into the Settlor's gross estate pursuant to IRC § 2042, which would defeat the purpose of the irrevocable life insurance trust.[47]

1.4.4.3. With IOTs, there is no concern about the Settlor having "incidents of ownership" over any of the trust assets, because the trust is intentionally designed so that the contents of the trust are brought back into the Settlor's estate for tax purposes.

1.5. Statutes, Cases, and Commentary.

1.5.1. Summary.

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[46] This bias is reflected by the rampant use of the pejorative term "defective" in referring to "Grantor Trusts" as "Intentionally Defective Grantor Trusts" when in fact there is nothing "defective" about these trusts at all.

[47] This fear, however, seems to be ungrounded; since PLR 200123034 (6/11/2001), attorneys have been drafting self-trusteed ILIT's. In PLR 200123034, a Grantor's transfer of assets into a self-trusteed irrevocable life insurance trust with Crummey provisions was determined by the IRS to be a completed transfer. The IRS found that Grantor had no right, title or interest in or power, privilege or incident of ownership in regard to any trust property, even though the Grantor was serving as the trustee of the trust and the Grantor retained the right to remove a trustee during Grantor's lifetime. *See* discussion on the ABA-PTL Archives, October 2007, at http://tinyurl.com/5ysdj3

1.5.1.1. So long as the Settlor retains rights to income only, then the underlying assets are protected from creditors, and are non-countable for Medicaid eligibility purposes, under the laws of most states. This statement is supported by the following sources:

1.5.2. Uniform Trust Code.

1.5.2.1. Section 505(a)(2) of the Uniform Trust Code states that "with respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit."[48]

1.5.2.1.1. The Uniform Trust Code has been enacted in 21 jurisdictions (Kansas, Nebraska, Wyoming, New Mexico, District of Columbia, Utah, Maine, Tennessee, New Hampshire, Missouri, Arkansas, Virginia, South Carolina, Oregon, North Carolina, Alabama, Florida, Ohio, Pennsylvania, North Dakota and Arizona). It is under study in numerous s other states.

1.5.2.1.2. Section 505(a)(2) of the Uniform Trust Code has been adopted in all of the enacting states without any significant change.

1.5.3. Restatement of Trusts, Second, Section 156.

1.5.3.1. The *Restatement (Second) of Trusts* Section 156 states the traditional rule as follows:

"(1) Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interest, his transferee or creditors can reach his interest.

"(2) Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit."

1.5.4. Treatises Supporting IOTs for General Asset Protection.

1.5.4.1. ***Asset Protection Strategies, Planning with Domestic and Offshore Entities*, page**

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[48] According to the Comment to § 505 of the Uniform Trust Code, this section does not address possible rights against a settlor who was insolvent at the time of the trust's creation or was rendered insolvent by the transfer of property to the trust. This subject is instead left to the State's law on fraudulent transfers. A transfer to the trust by an insolvent settlor might also constitute a voidable preference under federal bankruptcy law. The Uniform Trust Code also does not address creditor issues with respect to property subject to a special power of appointment. For creditor rights against such interests, the Comment to § 505 refers the reader to Restatement (Property) Second: Donative Transfers Sections [REST 2d PROP-DT] §§ 13.1-13.7 (1986). See also Sections 1.2.3 and 1.2.5 *infra*.

3, American Bar Association Section of Real Property, Probate and Trust Law, edited by Alexander A. Bove, Jr. (2002): "Another possibility is to create a trust for the benefit of the grantor and other family members, but to limit the grantor's interest in the trust. For example, the grantor could create a trust and direct the trustee to pay her the income and retain a testamentary special power of appointment over the principal. If the power was not exercised, the principal could pass to the children. Although the grantor's creditors could attach the income interest in such a trust, the principal would be protected under the laws of most states."

1.5.4.2. **Esperti, Peterson & Keebler, *Irrevocable Trusts: Analysis With Forms* §14.01 (WG&L 2007)**: "If the beneficiary cannot compel distributions, a creditor or transferee ordinarily cannot compel distributions either."

1.5.4.3. ***Asset Protection: Legal Planning, Strategies and Forms*, by Peter Spero ¶ 6.08[2] (WG&L 2007)**: "Where the settlor retains only a limited interest in a trust, the portion thereof not retained is afforded some protection even though it is self-settled. The settlor's creditors can reach trust assets to the maximum extent that the trustee could distribute or apply such assets for the settlor-beneficiary's benefit." *(citing* 2 A. Scott & W. Fratcher, *The Law of Trusts* (4th ed. 1987), § 156.2, at 175. *In re Shurley*, 115 F.3d 333 (5th Cir. 1997)).

"If the settlor-beneficiary creates a remainder interest in another person, then the settlor-beneficiary's creditors will not be able to reach the remainder interest if the trustee cannot reach the corpus for the settlor-beneficiary's benefit." (*citing* G. Bogert & G. Bogert, *Trusts and Trustees* (2d rev. ed. 1992), § 223, at 453).

1.2.2.6. ***Asset Protection Strategies: Tax and Legal Aspects*, by Lewis D. Solomon and Lewis J. Saret (CCH Tax and Accounting, 2006):** "One strategy the planner should consider would be to establish an irrevocable trust that:

1. Gives the Settlor an income interest in the irrevocable trust.
2. Gives the Settlor a special power of appointment over the trust corpus, only in favor of the objects of the Settlor's bounty (i.e. the Settlor's spouse or children).
3. Gives the trustee the discretionary power to distribute trust corpus among the objects of the Settlor's bounty. . . .
4. Includes a spendthrift provision in the trust instrument."

"This strategy has the following asset protection impact:

1. The settlor's retained income interest is exposed to the claims of creditors.
2. The settlor's creditor can not reach the trust corpus."

1.5.5. Treatises Supporting IOTs for Medicaid Asset Protection.

1.5.5.1. **Begley, Jr. & Hook, *Representing the Elderly or Disabled Client: Forms and Checklists with Commentary*** ¶ 7.02[2] (WG&L 2008): "Income-only trusts, which must be irrevocable, are permitted by OBRA'93.[49] The requirements were spelled out in a letter dated December 23, 1993.[50] Under the Richardson letter:

• "If there are any circumstances under which either income or trust corpus could be paid to the individual, then actual payments to the individual of either income or corpus are deemed 'income' for Medicaid eligibility purposes.

• "If trust corpus could be paid to an individual but is not, such asset is deemed an available resource for Medicaid eligibility purposes.

• "If no portion of the trust corpus may be distributed to an individual, i.e., an 'income only trust,' then no portion of the trust is deemed a resource of the individual for Medicaid eligibility purposes.

• "If some portion of the irrevocable trust corpus could be paid to an individual, and assets are transferred from the trust to someone other than the individual, then the individual is subject to the Medicaid three-year lookback."

"This left open the issue of whether a lookback period applied for transfers to or from an income-only trust. Even the Health Care Finance Administration (HCFA) was not sure which interpretation was correct.[51] HCFA finally clarified the rules in a letter dated February 25, 1998." [52]

1.5.5.1.1. The Streimer letter referenced above,[53] clarified the rules by stating as follows:

1.5.5.1.1.1. **For Transfers To an Income-Only Trust:**

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[49] *Citing* 42 USC § 1396p(d)(3)(B).

[50] *Citing* Letter from Sally K. Richardson, Director of Medicaid Bureau, Health Care Financing Administration, Dep't of Health and Human Services, to Elice Fatoullah, Elder Law Report, Vol. V, No. 7, p. 2, Dec. 23, 1993.

[51] *Citing* Q & A 83, Summary of Verbal Q & A's from HCFA Central to the Regions (Nov. 4, 1993).

[52] *Citing* Letter from Robert A. Streimer, Director, Disabled and Elderly Health Programs Group, Center for Medicaid and State Operation, Health Care Finance Admin., Dep't of Health and Human Services, to Dana E. Rozansky, Elder Law Report, Vol. IX, No. 9, p. 9, Apr. 1998.

[53] Available at http://www.sharinglaw.net/elder/Streimer.pdf.

"Transfers to an irrevocable trust with retained income only interests are considered available only to the extent of the income earned. Otherwise, the assets are considered to have been transferred with a 5-year lookback period."

1.5.5.1.1.2. **For Transfers From an Income-Only Trust:**

"[W]here assets in a trust can not be made available to the beneficiary, transfer of those assets to or for the benefit of someone other than the beneficiary does not incur a separate transfer penalty. Any penalty would have been assessed when the funds were placed in the trust."

1.5.5.2. **Frolik & Brown, *Advising the Elderly or Disabled Client*** (WG&L 2008) ¶14.04[5][c]: "If the grantor creates an irrevocable trust for his benefit or that of his spouse, the following rules apply:[54]

• "If the principal is payable to the grantor or the grantor's spouse, the principal is considered an available asset whether distributed or not, and transfers to a third party trigger a 60-month look-back period (36-month period prior to February 8, 2006);

• "If the principal cannot be distributed to the grantor or the grantor's spouse, it is not considered an available asset, but transfers to a third party trigger the 60-month look-back period;[55] and

• "If income can be distributed to the grantor or the grantor's spouse, it is considered income of the grantor, but the principal, if otherwise not distributable to or for the benefit of the grantor or the grantor's spouse, is not considered an available asset."

1.5.5.3. **Westfall & Mair, *Estate Planning Law and Taxation***, ¶13.05 (WG&L 2009): "With regard to an irrevocable trust, OBRA '93 provides that the trust principal is considered a countable resource if there are any circumstances under which payments from the trust principal could be made to or for the benefit of the settlor. If, on the other hand, the trustee may pay income but no principal to the settlor, it appears (although this issue has not been clarified by all state Medicaid agencies) that the principal will not be countable" (citations omitted).

1.5.6. Cases Supporting Use of IOTs.

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[54] *Citing* 42 USC § 1396p(d)(3)(B).

[55] Note: this is an incorrect statement of the law, as it ignores the logical and presumptively correct interpretation of 42 USC § 1396p(d)(3)(B) by HCFA as evidenced in the Streimer letter referenced *supra* in section 1.5.5.1.

1.5.6.1. ***Ware v. Gulda*, 331 Mass. 68, 117 N.E. 2d 137 (1957).** Held that where a settlor created for the settlor's own benefit a discretionary income-only trust (no principal distributions to the settlor were allowed), a creditor of the settlor could reach for satisfaction of a claim the maximum amount which the trustee could pay to the beneficiary or apply for the benefit thereof.

1.5.6.2. ***Paolozzi v. Commissioner*, 23 TC 182 (1954).** In this Tax Court case, the petitioner, Ms. Paolozzi, created a trust for herself where the trustee had discretionary power to distribute income only to the settlor. No principal distributions to the settlor were allowed in the trust. The Tax Court referred to both the above-quote Massachusetts Supreme Court case -- *Ware v. Gulda* -- and the above-quoted **Restatement of Trusts, Second** (section 1.5.3), in holding that the settlor's creditors could reach the maximum amount which, under the terms of the trust could be paid to the settlor. The Tax Court stated in its opinion:

> The rule we apply is found in Restatement: Trusts § 156 (2): "Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit." It has substantial support in authority. *Greenwich Trust Co. v. Tyson*, 129 Conn. 211, 224, 27 A. 2d 166; *Warner v. Rice*, 66 Md. 436, 8 A. 84; *Hay v. Price*, 15 Pa. Dist. R. 144; *Menken Co. v. Brinkley*, 94 Tenn. 721, 728-729, 31 S. W. 92; *Petty v. Moores Brook Sanitarium*, 110 Va. 815, 817, 67 S. E. 355; 27 L. R. A., N. S., 800; *Scott, Trusts*, § 156.2; *Griswold, Spendthrift Trusts* (2d ed.) § 481.

1.5.6.3. **In the Matter of Irene Spetz v. New York State Department of Health, 190 Misc. 2d 297; 737 N.Y.S.2d 524; N.Y. Misc. LEXIS 29 (2002)**. This case arose out of the Supreme Court of New York, and involved a claim by the State Medicaid Agency ("Agency") that the assets of the applicant's spouse's irrevocable trust[56] were countable for purposes of Medicaid. The Agency challenged the trusts on several grounds:

1.5.6.3.1. Although the terms of the trust made it irrevocable, Mr. Spetz (the Medicaid applicant's husband) reserved to himself the right to change the beneficiary. This right was limited, in that he was specifically prohibited from naming himself, his spouse, creditors of himself or his spouse, the estates of himself or his spouse or creditors of those estates. The Agency argued that because of this right, the trust

[56] The trust at issue allowed distribution only to the beneficiaries. The trustees had no power to pay principal or income to or for the benefit of the Settlor or his spouse. Although this is slightly different from the typical income-only trust, which does allow income to the Settlor, the design of the this trust otherwise seems virtually identical to most income-only trusts, and the findings and conclusions of law in this case apply equally to income-only trusts..

assets were in the "control" of Mr. Spetz and, therefore, must be considered in determining the eligibility of Mrs. Spetz to receive Medicaid benefits. The Agency also argued that the trust assets were available to Mr. Spetz because he could control the trustees under threat of appointing different beneficiaries if they refuse to comply. They asserted that the retention of the right to change beneficiaries is equivalent to control over the corpus of the trust.

1.5.6.3.2. The Court held that although it was conceivable that Mr. Spetz could bring pressure on the beneficiaries to make payments to or for Mrs. Spetz' benefit, the relevant law stated that the availability of assets, for Medicaid eligibility purposes, depends upon the "trustee's authority, under the specific terms of the trust agreement." The Court found that trustees of this trust had no such authority. The Court also stated that "[a]lthough the trustees and beneficiaries are currently the same people, that is not necessarily so under the terms of the trust, as respondents have pointed out, and, in any event, their roles as trustees and beneficiaries must be considered as legally separate."

1.5.6.3.3. The Agency also argued that under New York law (section 7-1.9 of the Estates, Powers and Trusts Law, which is similar to section 411 of the Uniform Trust Code), any trust can be revoked, provided that the beneficiaries consent, in writing, to the revocation. Thus, the Agency argued, the assets of the trust should be considered available to the Medicaid applicant because her husband could seek the consent of the trust's beneficiaries to revoke the trust, thus placing the corpus of the trust back in his hands. This is especially true, the Agency argued, since Mr. Spetz could possibly use his power to change beneficiaries in collusion with someone willing to revoke the trust.

1.5.6.3.4. The Court held that the speculative possibility of a revocation pursuant to New York law did not render the corpus of the trust "potentially available" to the petitioner, as there was no evidence presented that the beneficiaries would consent to such a revocation. "To hold otherwise would eviscerate the federal and state statutes providing, in detail, for the protection of assets through the use of irrevocable trusts, since every trust would be presumed to be revocable under section 7-1.9." The Court also found that the "claim that Mr. Spetz could somehow use his power to change the beneficiary in collusion with someone willing to revoke the trust is entirely speculative."

1.5.6.4. **Verdow v. Sutkowy, 209 F.R.D. 309 (N.D.N.Y. 2002)**. In this case, a federal court faced with a similar fact pattern to *Spetz,* except in the form of a federal class action, six elderly nursing home residents in New York State who created irrevocable, income-only trusts were denied Medicaid benefits because the trusts contained provisions reserving a limited power of appointment. County and state Medicaid officials determined that a limited power of appointment makes the assets of a trust an available resource for purposes of determining Medicaid eligibility.

1.5.6.4.1. The plaintiffs brought a suit under 42 U.S.C. § 1983 for themselves and others similarly situated against county and state Medicaid officials, alleging that consideration of the trust assets as an available resource is unlawful because there are no circumstances under which they could be paid the assets. Just as in *Spetz*, Medicaid officials argued that the plaintiffs could utilize their retained power to change beneficiaries to individuals amenable to revoking an otherwise irrevocable trust.

1.5.6.4.2. The U.S. District Court for the Northern District of New York granted the plaintiffs' motions for class certification and summary judgment, holding that "defendant's denial of plaintiffs' Medicaid benefits because they allegedly are potential beneficiaries of self-settled trusts containing limited powers of appointment exceeds the limits of federal law." The court further ruled that "absent evidence of bad faith or fraud, the decision of whether or not to provide Medicaid benefits should not be based upon the remote possibility of collusion."

1.5.6.5. All of the cases set forth in section 1.5.7 also support the conclusion that where a person creates a trust for his own benefit, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.

1.5.7. Specific Features of Income-Only Trusts.

1.5.7.1. **Retained General Powers Prohibited.**

> **Practice Tip:**
> Never allow a Settlor of an income-only trust, or the spouse of the Settlor, to retain a general power of appointment.

1.5.7.1.1. When a person transfers property in trust for himself for life and reserves a general power to change the beneficiaries, the interest subject to such retained power (even if the power is not exercised), and the settlor's retained life interest, can both be subjected to the payment of the claims of creditors of such person and claims against his estate to whatever extent other available property is insufficient for that purpose. *United States v. Ritter*, 558 F.2d 1165, 1167 (4th Cir. 1977).

1.5.7.1.2. In *Petty v. Moores Brook Sanitarium*, 110 Va. 815 (1910), the decedent created a "spendthrift trust" for his own benefit and retained a general power of appointment over the remainder. In denying creditor protection to the trust, the Court stated that "[in all trusts there must be a *cestui que trust*, and it is manifest from the deed that [the decedent] was to have the sole beneficial use of the property conveyed, certainly during his life, with power to dispose of what remained at his death by will." *Id.* at 817.

1.5.7.2. **Retained Limited Powers Permitted and Encouraged.**

1.5.7.2.1. A trust settlor often retains a limited power to change beneficiaries for a variety of purposes:

> **Practice Tip:**
> Consider allowing a Settlor of an income-only trust, or the Settlor's spouse, to retain a limited power of appointment over the trust corpus.

1.5.7.2.1.1. To maintain the ability to respond to changing family circumstances;

1.5.7.2.1.2. To respond to changing financial needs;

1.5.7.2.1.3. To prevent the imposition of a gift tax;

1.5.7.2.1.4. To ensure a step-up in tax basis on his or her death.

1.5.7.2.2. As a matter of both common law doctrine and the practicalities of the situation, the donee of a limited power of appointment is not the owner of the appointive assets. The donee is in a fiduciary position with reference to the power and cannot derive personal benefit from its exercise. The donee's creditors have no more claim to the appointive assets than to property which the donee holds in trust. It is immaterial whether or not the donee exercises the power.[57]

1.5.7.2.3. If the donee formerly owned the appointive assets covered by the non-general power *and transferred them in fraud of the donee's creditors*, reserving the non-general power, *the creditors can reach the appointive assets under the rules relating to fraudulent conveyances*. The fact that a non-general power was reserved by the donee in such fraudulent conveyance does not increase or decrease the ability of the creditors to reach the appointive assets.[58]

1.5.7.2.4. **Illustration:** O by deed transfers property to T in trust. T is directed to pay the net income to O for life. In addition, T is directed "to distribute the trust property to, or hold the same for the benefit of, O's issue who are living from time to time, in such amounts and proportions and for such estates and interests and outright or upon such terms, trusts, conditions, and limitations as O shall appoint during O's lifetime; and on O's death, to the extent the trust property is not otherwise disposed of by an exercise of O's power to appoint, the trust property shall pass to O's issue then living, such issue to take per stirpes, and if no issue of O is then living, to the

[57] REST 2d PROP-DT § 13.1(b), cmt. a.

[58] REST 2d PROP-DT § 13.1(b).

X charity."[59]

1.5.7.2.5. **Explanation:** O is both the donor and donee of O's non-general power to appoint. O's creditors can reach the life income interest under the trust which O owns. They can also reach the property that is subject to O's non-general power **if the transfer is in fraud of O's creditors under the governing law as to fraudulent conveyances**.[60]

1.5.7.2.6. **Gift in Default of Appointment to Donee's Estate**: If the gift in default of appointment is to the donee's estate, the donee's power, though in form a non-general power, is in substance a general power, and is therefore not protected from the donee's creditors.[61]

1.5.7.2.7. **Supportive Case Law:** Commenting on the limited number of cases involving the point, the American Law of Property concludes that this is likely due to "a general acknowledgment of the rather obvious principle" that property under a non-general power is not available to creditors of the donee.[62]

1.5.7.2.7.1. One of the few cases is *Egbert v. De Solms*, 218 Pa. 207, 67 A. 212 (1907). In that case a husband and wife executed a trust whereby the wife was to receive the income from the trust during her lifetime, to be followed after her death by a life interest for the husband, and at his death the principal to be divided among their issue in such shares as the husband should by will appoint. The court held that while the income payable to the parents was subject to the payment of their debts, the issue's remainder estate could not be defeated. "Except as against existing creditors, or those in specific contemplation in the immediate future, the [settlors] could have conveyed a present absolute estate to their children; and *a fortiori* they could convey an estate in remainder." *Id.* at 209, 67 A. at 212-13.

1.5.7.2.7.2. The fact that a donee exercises the power, while significant when

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[59] REST 2d PROP-DT § 13.1(b).

[60] REST 2d PROP-DT § 13.1(b).

Note that the rule of REST 2d PROP-DT §13.1 applies to non-general powers, i.e., powers that are not exercisable in favor of any one or more of the following: the donee of the power, the donee's creditors, the donee's estate, or the creditors of the donee's estate. *See* Reporter's Note to § 13.1.

Note also that in bankruptcy law, where there has been a tendency to go further in allowing creditors access to property over which the debtor has a power of appointment than under the common law, property covered by a non-general power has never been subject to the claims of creditors. See *Drummond v. Cowles*, 278 F. Supp. 546 (D. Conn. 1968) and the Reporter's Note to REST 2d PROP-DT, § 13.6, item 3.

[61] REST 2d PROP-DT §13.1(c)

[62] REST 2d PROP-DT §13.1(c), citing 5 *American Law of Property* § 23.15 (A.J. Casner ed. 1952).

dealing with a general power, makes no difference when the power is a limited one; creditors cannot reach the appointive property in either case.

1.5.7.2.7.2.1. In *Prescott v. Wordell*, 319 Mass. 118, 65 N.E.2d 19 (1946), the executors contended that, because the donee exercised her non-general power in her will, the will had the effect of making the appointed property assets of her estate in so far as her creditors were concerned. The court, pointing to § 326 of the first Restatement of Property, held that since the donee had no power to appoint to her own estate or for the benefit of her creditors, her exercise of the power did not subject the appointed property to the payment of her debts.

1.5.7.2.7.2.2. The Maryland high court in *Price v. Cherbonnier*, 103 Md. 107, 63 A. 209 (1906), held invalid an attempted testamentary appointment to certain creditors since they were not objects of the donee's non-general power. Further, the attempted exercise did not render the property assets of the estate subject to the claims of creditors. Dictum to the same effect (that ineffectively appointed property under a non-general power cannot be reached by the donee's creditors) appears in *Fiduciary Trust Co. v. First National Bank of Colorado Springs*, 344 Mass. 1, 7, 181 N.E.2d 6, 10 (1962).

1.5.7.2.7.2.3. In a more recent Maryland case, the Court held that a settlor's retained limited power of appointment is not sufficient to allow the creditor to seize trust assets. In *United States v. Baldwin*, 283 Md. 586, 391 A.2d 844 (1978), Baldwin had transferred property to a trust, reserving to himself the right to receive the income from the trust property for life and a power of appointment by will to designate those persons who would receive and enjoy the remainder after his death. The Maryland Court of Appeals held in *Baldwin* that the power of appointment, under Maryland law, was a special or limited power which did not permit Baldwin to appoint the corpus to his own estate or to his creditors. Such a limited power of appointment of the corpus, coupled with the life estate, did not give Baldwin such a property interest in the corpus as to subject it to the claims of his creditors. *Id.*

1.5.7.2.7.2.4. The Connecticut case of *Ahern v. Thomas*, 248 Conn. 708, 739, 733 A.2d 756, 775 (1999) involved a nursing-home resident who appealed denial of her Medicaid application following administrative determination that the principal of the trust she had established was an available resource for purpose of calculating her Medicaid eligibility. The trial court reversed. Affirming, the Connecticut high court held that because the trust instrument did not provide trustees with authority or discretion to distribute trust principal to settlor, the principal of the trust was not an available resource.

1.5.7.2.7.2.5. In another Connecticut case, after a dissolution of marriage was granted, a Connecticut intermediate appeals court reversed and remanded,

holding that no portion of the husband's spendthrift trust assets could be included in the marital estate and awarded to the wife, as the husband had only a limited power of appointment and no interest in the appointive assets of the trust. *Cooley v. Cooley*, 32 Conn. App. 152, 161, 628 A.2d 608, 614, *cert. denied* 228 Conn. 901, 634 A.2d 295 (1993).

1.5.7.2.7.2.6. In a Georgia case, *Avera v. Avera*, 253 Ga. 16, 315 S.E.2d 883 (1984), a settlor created a trust whereby he would receive the income of the trust while retaining a limited power of appointment. The trustee could invade the corpus of the trust for the settlor's benefit, but that power was subject to an ascertainable standard. The Supreme Court of Georgia held that principal of the trust could not be invaded to satisfy a claim against the settlor arising out of a divorce since the trustee's discretion to make distributions to the settlor was limited by an ascertainable standard. The court so held even though the settlor retained a limited power of appointment. The court also noted that there was always one other beneficiary of the trust, even though the settlor could change that beneficiary.[63]

1.5.7.2.7.2.7. The New York case of *Spetz*[64] and the New York federal case of *Sutkowy,*[65] both previously discussed, were Medicaid cases involving irrevocable trusts with retained lifetime limited powers of appointment. The Medicaid Agency in both cases claimed that the Settlors could use their retained lifetime limited power to change the beneficiaries to individuals willing to revoke the trust. Both courts, relying on the same logic, rejected this argument as being entirely speculative, holding that denial of Medicaid benefits could not be based upon a remote possibility of collusion absent bad faith or fraud.[66]

1.5.7.2.7.2.8. Despite these favorable results in *Spetz* and *Sutkowy*, this writer believes it is preferable to use a retained testamentary limited power rather than a lifetime power, so as to avoid the argument raised by the Medicaid agencies in *Spetz* and *Sutkowy*.

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[63] REST 2d PROP-DT §13.1(c) (also citing *DiMaria v. Bank of Cal. Nat'l Ass'n*, 237 Cal. App. 2d 254, 46 Cal. Rptr. 924 (1965) (self-settled trust could not be reached where trustee's power to invade and distribute to settlor/beneficiary was limited by an ascertainable standard)).

[64] *See supra*, section 1.5.6.3.

[65] *See supra*, section 1.5.6.4

[66] *Supra*, sections 1.5.6.3 and 1.5.6.4.

1.5.7.2.8. **Non-Supportive Treatise and Case Law.**

1.5.7.2.8.1. According to treatise author Peter Spero (a certified specialist in tax law and a member of the California bar), the retention of a limited power of appointment by a transferor will be taken into account by courts in determining whether the transfer of property is effective or an avoidable fraudulent transfer.[67]

1.5.7.2.8.1.1. **Note:** This writer, as supported by REST 2d PROP-DT §13.1, believes that Mr. Spero, and many of the courts in the opinions he cites (presented below), have misconstrued the doctrine of fraudulent conveyance by improperly intertwining the conveyance itself with the retained powers held by the conveyor, which are two completely separate issues and must be viewed separately.

1.5.7.2.8.2. In resolving this issue, Mr. Spero states that "courts often consider the incidents of ownership, which include not only present enjoyment, but also the power to ultimately dispose of the property. The more incidents of ownership the settlor retains, the more likely the arrangement will not be effective to secure the property from the settlor's creditors."[68]

1.5.7.2.8.2.1. **Note:** Again, this writer believes that Mr. Spero and some courts are confused. This writer, as supported by REST 2d PROP-DT §13.1, disagrees that "the power to ultimately dispose of the property" is necessarily an "incident of ownership." If the "power to ultimately dispose of the property" is bestowed via a **general** power, then it would certainly constitute an "incident of ownership" sufficient to subject the trust the property to creditors of the power holder. However, if the "power to ultimately dispose of the property" is bestowed via a **limited** power, then it would not constitute an "incident of ownership" and therefore should not subject the trust the property to creditors of the power holder.

1.5.7.2.8.3. Mr. Spero says that "it is unclear how much control the grantor can retain and still protect the property." [69] In support of this statement, he cites several cases that have held that a retained limited power does not invalidate the creditor protection aspects of a properly-drafted irrevocable trust (including some of those listed in section 1.5.7.2.7), and several cases have held that no retained power is allowed:

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[67] Spero, *Asset Protection: Legal Planning, Strategies and Forms* ¶13.10[3].

[68] Spero, *Asset Protection: Legal Planning, Strategies and Forms* ¶13.10[3].

[69] Spero, *Asset Protection: Legal Planning, Strategies and Forms* ¶13.10[3].

1.5.7.2.8.3.1. In the Pennsylvania case of *In re Nolan*, 218 Pa. 135, 67 A. 52 (1907) *(see supra* Section 1.2.5), the settlor retained the power to appoint the remainder and the trustee had the power to reconvey the property to the settlor. In holding that no creditor protection was available, the court unfortunately did not specifically refer to the trustee's power to reconvey the property to the settlor. The Court stated:

"It is against public policy, and not consonant with natural justice and fair dealing as between debtor and creditor, that a settlor should be permitted to play fast and loose with his property, in such a manner as to have the use of the income during life, and the right to disposing of the principal by will at any subsequent time he chooses to exercise the power, thus giving him all of the substantial benefits arising from the ownership thereof while he has safely put his property beyond the reach of creditors." [70]

1.5.7.2.8.4. Similarly, in *First National Bank v. Schwab*, 194 So. 307, 309 (1940), the settlor transferred property to a trust while retaining a life estate, and the power to change the trustee and beneficiary. The court held that these retained powers established that he did not intend to place property out of his control and that the transfer was a mere contrivance that was not effective with regard to his creditors.[71]

1.5.7.2.8.5. Further, Mr. Spero says that "it has been observed that a power to change beneficiaries is similar to a power to terminate the trust and revest corpus in the settlor, since generally the beneficiaries and the settlor can terminate the trust. If the settlor selects the beneficiary, such as a close relative, in advance, and creates an agreement or understanding with the beneficiary, he would effectively have the power to revoke the trust."[72]

1.5.7.2.8.6. However, absent proof of such advance agreement or understanding, and absent proof that the beneficiaries would actually consent to such a revocation, it is extremely unlikely that a court would invalidate such trust. As the Court noted

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[70] Spero, *Asset Protection: Legal Planning, Strategies and Forms* ¶13.10[3]. Note that the *In re Nolan* Court did not mention in its holding that the trustee had the power to reconvey the property to the settlor. This writer presumes that it was the trustee's power to reconvey the property to the settlor, in addition to the limited power of appointment, that irked the Court and resulted in this anomalous holding.

[71] In the *Schwab* case, the Settlor not only retained a limited power of appointment, but also the trustee was given the power to reconvey the property to the settlor. This writer presumes that it was the trustee's power to reconvey the property to the settlor, in addition to the retained limited power of appointment, that particularly irked the Court and resulted in this anomalous holding.

[72] Spero, *Asset Protection: Legal Planning, Strategies and Forms* ¶13.10[3], *citing* annotation, "Exercise of Power to Appoint Validity," 115 A.L.R. 930, 937 (1938) (an appointment under a limited power is void if made pursuant to a prior agreement that the property appointed will be paid back to the appointer).

in the case of *Spetz v. New York State Department of Health*,[73] to hold otherwise would eviscerate the federal and state statutes providing, in detail, for the protection of assets through the use of irrevocable trusts, since every trust would be presumed to be revocable under section 411 of the Uniform Trust Code and related state statutes and common law.

1.6. Taxation of Income-Only Trusts.

1.6.1. Income Tax.

1.6.1.1. Because all trust income flows through the trust to the Settlor, the income-only trust is considered by the IRS to be a "grantor trust."[74] Through use of an income-only trust, the ordinary income of the trust is paid directly to the settlor/grantor and the tax will be paid at the settlor's tax rate,[75] rather than by the trust at the compressed trust tax rates.

1.6.2. Income Tax Reporting.

1.6.2.1. If the Settlor of a grantor trust is also a trustee or co-trustee, a separate taxpayer identification number is not required and a separate tax return (Form 1041) need not be filed by the trustee.[76]

1.6.2.2. However, for asset protection purposes, it is preferable for the trust to obtain a separate tax identification number so that potential creditors, including Medicaid, will clearly see the trust as a separate entity.

1.6.2.3. The Rules for reporting income are contained in the Instructions for Form 1041, under the section entitled "Grantor Type Trusts." The trustee does not show any dollar amounts on the form itself dollar; amounts are shown only on an attachment to the

Practice Tip:
Consider preparing the Grantor Tax Statement for the Settlor's income-only trust, at least for the first year.

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[73] *See infra* section 1.5.6.3.

[74] IRC § 677 and Treas. Reg. §1.671-2.

[75] *Begley, Jr. & Hook, supra at* § 7.20[6][a]. The trust can provide that income shall be distributed to the grantor or may be distributed to the grantor at the discretion of the trustee. From a Medicaid standpoint, it is better to permit the trustee to use discretion in distributing income. From an income tax standpoint, it is usually better to distribute the income to the grantor to avoid income tax at the trust's highly compressed tax rates. *Id.* § 7.02[7][a].

[76] *See* IRS Instructions for From 1041, "Optional Method 1" under "Special Filing Instructions for Grantor Type Trusts."

form (typically called a Grantor Trust Statement) that the trustee or tax preparer files. The trustee should not use Schedule K-1 as the attachment nor issue a 1099.

1.6.3. Gift Tax.

1.6.3.1. Because the income-only trust is typically designed so that the settlor retains a limited power of appointment in the trust corpus, transfers to an income-only trust are not considered completed gifts for gift tax purposes.[77]

1.6.3.1.1. When a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift.[78]

1.6.3.1.2. A gift is incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves.[79]

1.6.4. Gift Tax Reporting.

1.6.4.1. Even though the transfer of assets into the trust is not considered a taxable gift, pursuant to Treas. Reg § 25.6019-3 a Form 709, U.S. Gift (and Generation Skipping Transfer) Tax Return should still be filed in the year of the initial transfer into the trust.[80] On the Form 709, the transaction should be shown on the return for the year of the initial transfer and evidence showing all relevant facts, including a copy of the instrument(s) of transfer and a copy of the trust, should be submitted with the return.[81] The penalty for not filing a gift tax return is based on the amount of gift tax due, so if there is no amount due

> **Practice Tip:**
> Consider preparing the Gift Tax Return and attachments for transfer of assets into the Settlor's income-only trust.

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[77] Treas. Reg. § 25.2511-2(b).

[78] Treas. Reg. § 25.2511-2(b).

[79] Treas. Reg. § 25.2511-2(b).

[80] *See* Treas. Reg § 25.6019-3, which states that "[i]f a donor contends that his retained power over property renders the gift incomplete . . . and hence not subject to tax . . . , the transaction should be disclosed in the return for the . . . calendar year of the initial transfer and evidence showing all relevant facts, including a copy of the instrument of transfer, shall be submitted with the return. . . [along with] additional documents the donor may desire to submit."

[81] Treas. Reg § 25.6019-3.

there should be no penalty for failure to file. Nevertheless, a gift tax return should be filed pursuant to Treas. Reg § 25.6019-3. Additionally, the filing of a gift tax return could provide additional evidence to future creditors, including Medicaid, that a completed transfer was in fact made despite the fact that the transfer was not considered by the IRS to be a completed gift for tax purposes.

1.6.4.2. Neither Treas. Reg § 25.6019-3 nor the IRS Form 709 Instructions reveal how to report an incomplete gift. However, Treas. Reg § 301.6501(c)-1(f)(2) provides in relevant part as follows:

"A transfer will be adequately disclosed on the return only if it is reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value so reported. Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed under this paragraph (f)(2) if the return (or a statement attached to the return) provides the following information—

(i) A description of the transferred property and any consideration received by the transferor;

(ii) The identity of, and relationship between, the transferor and each transferee;

(iii) If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument."

1.6.4.3. Although the transfer to the trust is an incomplete gift for gift tax purposes, if the trustee later distributes corpus from the trust to one or more of the beneficiaries, the tax result of such distribution is that a completed gift has now been made from the trust settlor to the beneficiary. Accordingly, a gift tax return should be filed by the settlor for the tax year of such distribution if the amount of such distribution exceeds the annual exemption amount.

1.6.5. Estate Tax.

1.6.5.1. The corpus of the trust is taxable in the Settlor's estate upon death under IRC Section 2036, which says that "[t]he 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 . . . under which he has retained for his life . . . the possession or enjoyment of, or the right to the income from, the property . . . ."[82]

[82] IRC § 2036 and Treas. Reg. §20.2036-1

1.6.5.2. If the Settlor retains a limited power of appointment in the trust corpus, the entire value of the estate is included in the settlor's estate for estate-tax purposes.[83]

1.6.6. Step Up in Basis.

1.6.6.1. Because an income-only trust is designed so that assets are included in the estate of the Settlor, the trust beneficiaries will receive a step up in tax basis as to trust assets to the fair market value of the assets as of the Settlor's death.[84]

1.6.7. Capital Gains Exclusion for Sale of Principal Residence.

1.6.7.1. If a taxpayer is considered the owner of the entire Trust (including the residence) under the Grantor Trust rules,[85] the taxpayer will be treated as the owner of the residence for purposes of satisfying the ownership requirements of § 121 of the Internal Revenue Code.[86]

1.6.7.2. Accordingly, by transferring a residence to an income-only trust in which the settlor retains a testamentary limited power of appointment, the exclusion from capital gains on the sale of a principal residence is maintained.[87]

1.7. Comparison of IOTs with Offshore APTs and Domestic APTs.

1.7.1. Source of Confusion.

1.7.1.1. The plain meaning of the term "self-settled trust" is a trust established by a settlor for his own benefit. Such plain meaning would obviously include a long list of various types of trusts, including revocable trusts and all types of irrevocable trusts from which the settlor can derive any benefit.

1.7.1.2. Unfortunately, the term "self-settled trust" is a widely misused term that has

Practice Tip:
To ward off confusion, explain to clients and their advisors that the term "self-settled trust" is a "term of art" – specifically describing an irrevocable trust where the settlor's goal is asset protection but the settlor is allowed to receive distribution of principal in addition to income.

[83] Begley, Jr. & Hook, *supra* at § 7.20[6][c].

[84] See also IRC § 1014(b)(3), Treas. Reg. §§1.1014-2(a)(3), 1.1014-2(b).

[85] IRC §§ 671-679.

[86] See Rev. Rul. 85-45 (1985) and PLR 199912026 .

[87] Begley, Jr. & Hook, *supra* at § 7.20[6][e].

created a great deal of confusion in the legal profession. In almost all legal treatises, articles, and reported cases, the term "self-settled trust" is used not in the sense of its plain meaning, but rather as a "term of art" – specifically describing an irrevocable trust where the settlor's goal is asset protection yet the settlor is also a beneficiary as to both income and principal.

1.7.1.2.1. Under traditional trust law, this type of "self-settled trust"[88] has never been effective for asset protection purposes because, as explained in detail in section 1.5, if a settlor has the right to receive distributions of principal from the trust, then so do his creditors, because a creditor of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit.

1.7.1.2.2. Under current law, this type of "self-settled trust" is absolutely ineffective for Medicaid asset protection purposes because, as explained in detail in section 1.2.4, if either spouse has access to principal, the assets in the trust will be deemed "countable" for Medicaid eligibility purposes.

1.7.2. Clearing Up the Confusion About "Self-Settled" Trusts.

1.7.2.1. What has confused many practitioners is that most authors of articles and treatises on asset protection trusts, and many judges in reported decisions, use the term "self-settled trust" indiscriminately, without explaining that they are using it as a term of art, intending to refer to a very specific type of "self-settled trust," *i.e.*, an irrevocable trust where the settlor is allowed to receive distributions of both income and principal.

1.7.2.1.1. An IOT is certainly a "self-settled trust" within the plain meaning of the term, but it is not a "self-settled trust" as that term is currently used in the legal profession because it does not allow the Settlor the right to receive distributions of principal, but rather only distributions of income and the right to use any trust-owned real estate.

1.7.2.1.1.1. An income-only trust has always allowed complete protection of the settlor's assets as explained in section 1.5 because the settlor does not retain any right to the return of corpus. An IOT does not protect the income generated by the trust assets, but it does protect the underlying assets, which is what most clients care about most, and is what "asset" protection is all about.

1.8. Fraudulent Transfers.

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[88] For uniformity with other commentators, the term "self-settled trust" will (reluctantly) be used herein to refer specifically to a self-settled trust intended to protect the settlor's assets while allowing the settlor to receive distributions of principal directly from the trust corpus, unless stated otherwise.

1.8.1. Applicability.

1.8.1.1. No asset protection trust (or any other asset protection entity) is designed to protect assets that have been fraudulent transferred.

1.8.1.2. Funding of IOTs should only occur while a client is essentially free from financial difficulties.

1.8.2. UFTA.

1.8.2.1. Most U.S. jurisdictions follow the 1984 Uniform Fraudulent Transfer Act ("UFTA"), which allows creditors to set aside a fraudulent transfer and enforce the judgment against the assets as if the fraudulent transfer never took place.[89]

1.8.2.1.1. With respect to present creditors, Section 5(a) of the UFTA provides that: "[a] transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the debtor made the transfer and the debtor was insolvent at the time or the debtor became insolvent as a result of the transfer."

1.8.2.1.2. With respect to present and future creditors, Section 4(a) of the UFTA provides:

"A transfer made by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made, if the debtor made the transfer:

(1) with actual intent to hinder, delay or defraud any creditor or the debtor, or

(2) without receiving a reasonably equivalent value in exchange for the transfer and:

(a) the debtor intended to incur, or believed or reasonably should have believed that he/she would incur debts beyond his/her ability to pay as they became due; or

(b) the debtor was engaged or was about to engage in business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction.

1.8.2.1.3. UFTA has a four-year statute of limitations but contains a one-year discovery exception to that limitations period, meaning that if a creditor reasonably

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[89] Shaftel and Bundy, *Impact of New Bankruptcy Provision on Domestic Asset Protection Trusts*, *supra*.

discovers a transfer to an IOT after the four-year limitations period has expired, the creditor has an additional year in which to file an action and argue that the transfer to the IOT was made with the intent to hinder, delay, or defraud the creditor.

1.8.3. BAPCPA.

1.8.3.1. On 4/20/05, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The key operative language of the relevant amendment (11 U.S.C. §548(e)) to the 2005 Bankruptcy Act states that the bankruptcy trustee:

> "may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if--
> (A) such transfer was made to a self-settled trust or similar device;
> (B) such transfer was by the debtor;
> (C) the debtor is a beneficiary of such trust or similar device; and
> (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted."[90]

1.8.3.1.1. The operative language in subsection D is identical to the existing fraudulent transfer language of Bankruptcy Code section 548(a)(1)(A), with the two-year limitations period extended to ten years. Similarly, the operative language "actual intent to hinder, delay, or defraud" is identical to the language used in the Uniform Fraudulent Transfer Act ("UFTA").[91]

1.8.3.1.2. Accordingly, the result of the 2005 Bankruptcy Act is that Congress extended the section 548 fraudulent transfer remedy, duplicating a remedy that already existed in the 42 states that have adopted UFTA, the only significant difference being a fixed ten-year limitations period instead of four years plus a one-year discovery period.[92]

1.8.3.1.3. The consequence of this amendment is that it now provides a uniform fraudulent transfer remedy in all 50 states. However, because the IOT is not intended to allow fraudulent transfers, the 2005 Bankruptcy Act does not change the effectiveness of an IOT that is properly used for asset protection, *i.e.,* established and

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[90] 11 USC § 548(e)(1).

[91] Shaftel and Bundy, *Impact of New Bankruptcy Provision on Domestic Asset Protection Trusts*, *supra*.

[92] Shaftel and Bundy, *Impact of New Bankruptcy Provision on Domestic Asset Protection Trusts*, *supra*.

funded while a client is essentially free from financial difficulties.[93]

1.8.4. Fraudulent Transfers as to Future Creditors.

1.8.4.1. Transfers to IOTs made "with actual intent to hinder, delay, or defraud any entity to which the debtor was *or became, on or after the date that such transfer was made, indebted*" (emphasis added) are voidable under new Bankruptcy Code § 548(e). The prior version of Bankruptcy Code § 548 contained the same language. The parallel UFTA provision applies "whether the creditor's claim arose before or after the transfer." UFTA § 4(a).

1.8.4.2. Although this definition appears to encompass virtually any creditor, case law has narrowly defined "future creditor."[94] The general rule under UFTA is that transfers motivated out of mere caution, as opposed to fraudulent intent, and made at a time when one does not have creditors, generally do not constitute fraudulent transfers.[95] In fact, for purposes of the fraudulent transfer laws, the term "future creditor" may be a misnomer, because it generally means a creditor who presently holds contingent, unliquidated, or unmatured claims, all of which are included in the definition of the term "claim" under the various fraudulent transfer laws.[96]

1.8.4.3. In order for a transfer to be made with the requisite fraudulent intent directed toward a specific future creditor, such intent must be contemporaneous with the transfer, or there must be some other connection between the two elements so that it can be said that the transfer was intended to injure that specific future creditor.[97]

1.8.4.4. Under the weight of authority, transfers made to avoid"unknown future creditors" are not avoidable under the UFTA; however, there are some contrary cases that appear to be aberrational.[98]

1.8.4.5. One important question is whether the Bankruptcy Code provisions (including the

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[93] Shaftel and Bundy, *Impact of New Bankruptcy Provision on Domestic Asset Protection Trusts*, *supra*.

[94] Spero, *Asset Protection: Legal Planning, Strategies and Forms* at ¶ 3.03[4][a], *citing Stratton v. Edwards*, 174 Mass. 374, 378, 54 NE 886, (1899); *Williams v. Banks*, 11 Md. 198, 227 (1857); *Winchester v. Charter*, 94 Mass. (12 Allen) 606, 609–611 (1866).

[95] Spero, *Asset Protection: Legal Planning, Strategies and Forms* at ¶ 6.09[1].

[96] Spero, *Asset Protection: Legal Planning, Strategies and Forms* at ¶ 3.03[4][a].

[97] Spero, *Asset Protection: Legal Planning, Strategies and Forms* at ¶ 3.03[4][a], *citing* G. Glenn, Fraudulent Conveyances and Preferences § 319, at 557 (rev. ed. 1940).

[98] Spero, *Asset Protection: Legal Planning, Strategies and Forms* at ¶ 6.09[1].

2005 Bankruptcy Act provisions) will be interpreted in the same way as the UFTA provisions; that is, will a transfer made out of mere caution be avoidable as a fraudulent transfer? The Bankruptcy Code and the UFTA are read by reference to each other (i.e., *in pari materia*). Using this rule of interpretation, it would appear that the 2005 Bankruptcy Act's fraudulent transfer provisions would be interpreted in a way that would not prohibit transfers made with respect to unknown creditors (i.e., transfer motivated by mere caution). But a contrary interpretation is possible. The Bankruptcy Code provisions, although similar to the UFTA provision, is not identical, and the policy concerns are different so the result might be different. In any event these musings are clearly speculative and the matter will ultimately be subject to the vicissitudes of future judicial proceedings.[99]

1.8.5. Is Medicaid a Creditor?

1.8.5.1. An interesting question in the context of using IOTs for Medicaid asset protection is whether Medicaid is considered a "creditor" under fraudulent transfer laws. Whether Medicaid is or is not a creditor is determined by State law, as Federal law is silent on the issue.[100]

1.8.5.2. To some extent, the question of whether Medicaid is considered a creditor under the Bankruptcy Code and UFTA is moot because of the application of the Medicaid 5-year lookback period[101] which effectively takes the place of the fraudulent transfer rules in the context of Medicaid.

1.8.5.3. Nevertheless, there are two types of transfers that could be looked at in connection with this inquiry – the initial transfer by a Settlor into an IOT and any subsequent transfer by a Trustee of an IOT to beneficiaries other than the Settlor.

1.8.5.4. Transfers by a Settlor into an IOT established for estate planning and asset protection purposes while a client is relatively healthy and essentially free from financial difficulties, made without actual or constructive fraudulent intent, should clearly protect the assets from future creditors of the Settlor, including Medicaid (if Medicaid is considered a creditor under the prevailing State law).

1.8.5.5. Once assets have been transferred into an IOT, they are no longer legally owned by

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[99] Spero, *Asset Protection: Legal Planning, Strategies and Forms* at ¶ 6.09[1].

[100] *See* Whitenack, Mazart, and Spielberg, *The Revival of the Income-Only Trust in Medicaid Planning*, *supra*., p. 37, stating that in some states Medicaid is not considered a creditor, and *citing Matter of Tomeck*, 872 NE2d 236 (2007), for the finding that a transfer of the marital home to an income-only trust does not violate debtor/creditor law.

[101] *See supra* section 1.2.1.2.

the Settlor; thus any future distribution from the IOT is not a transfer by the Settlor, and therefore logically can not be considered a fraudulent transfer by the Settlor.

1.8.5.6. Logically, a distribution from an IOT can only give rise to a fraudulent transfer claim if the creditor has a claim against the IOT itself, *i.e.*, against trustee of the IOT in his representative capacity as trustee. Does the trustee of an IOT engage in a fraudulent transfer by distributing trust principal to beneficiaries other than the Settlor (or reallocating trust investments to reduce income) prior to filing for Medicaid, knowing that this will result in a loss of income by the Settlor and therefore less income available to contribute to Medicaid? The answer to this question ought to be no because, prior to filing, Medicaid is never a creditor of the IOT. Medicaid may be a creditor (or future creditor) of the Settlor, and the Settlor may be a creditor of the IOT (based on the Settlor's right to receive income from the IOT), but this does not make Medicaid a creditor of the IOT unless and until the Settlor assigns his income interest in the IOT to Medicaid, which would never happen prior to filing for Medicaid.

SECTION 2. TRUSTS FOR VETERAN'S ASSET PROTECTION PLANNING

2.1. Basic Overview of Veteran's Asset Protection Planning.

2.1.1. Purpose.

2.1.1.1. The Purpose of Veteran's Asset Protection Planning is to protect a wartime veteran's assets in order to qualify the veteran to receive the Veteran's Aid and Attendance special pension benefit to assist the Veteran in paying for long-term care, typically care delivered at home or in an assisted living facility. Of course, like Medicaid, the Veteran's Aid and Attendance special pension benefit has its own complex financial requirements that must be met.

2.1.1.2. Meeting the financial requirements is often a difficult hurdle for a veteran seeking aid and attendance benefits, and the use of an irrevocable trust can provide a helpful planning tool.

2.2. The Law.

2.2.1. United States Code.

2.2.1.1. Title 38 United States Code is the section that applies to veterans' benefits. Other sections of the United States Code have a bearing on VBA as well, such as Title 5 U.S.C. which concerns government organization and employees and Title 10 U.S.C. which pertains to the military.

2.2.1.2. The United States Code gives the Secretary of Veterans Affairs the authority to prescribe all rules and regulations which are necessary or appropriate to carry out the laws administered by the Department and are consistent with those laws. (Section 501, Title 38 U.S.C.)

2.2.2. Code of Federal Regulations

2.2.2.1. The Secretary's rules and regulations are contained in Title 38 of the Code of Federal Regulations (38 CFR.). The Compensation and Pension Service writes the regulations that pertain to the adjudication of claims for compensation, pension and other benefits that are processed by adjudication personnel. All regulations (proposed and final) are published in the Federal Register. One of the functions of the General Counsel is to give a written interpretation of the law whenever necessary.

2.2.3. Directives and Records

2.2.3.1. Directives provide instructions to VA personnel. There are different forms of directives but the ones most commonly encountered are Circulars (used when required for special projects, to implement a program with an ending date, to implement instructions subject to frequent change, or to test a procedure) and Manuals (designed to provide procedures for benefit payments and, in general, for all the work everyone in VA does).

2.2.3.2. The primary document used for Veterans Aid and Attendance is a Manual – specifically **M21-1: Adjudication Procedures.** See the VA website here for more information: http://www.benefits.va.gov/WARMS/Site_Map.asp.

2.3. Transfers and Look Back.

2.3.1. No Look Bank Period and No Transfer Penalty.

2.3.1.1. The VA does not generally penalize veterans for transfers of assets and does not yet have a formal “look-back” period, but evaluates the veteran's financial condition at the time of the application.

2.4. Amount of the Benefit

2.4.1. Aid & Attendance Amounts:

Aid and Attendance Benefit	Annual	Monthly
Single Veteran	$20,447.00	$1,703.92

Married Veteran	$24,239.00	$2,019.92
Surviving Spouse of Veteran	$13,138.00	$1,094.83
Both Spouses Veterans	$31,578.00	$2,631.50

2.5. Who Is Eligible?

2.5.1. Service Eligibility.

2.5.1.1. To receive the Veterans Aid & Attendance Special Pension Benefit, or the Housebound Special Pension Benefit, which is similar but pays less than Aid & Attendance (hereinafter I will refer to both of these benefits as the "Veterans Pension"), a veteran must have served on active duty, at least 90 days, at least one day of which occurred during a period designated as wartime:

2.5.1.2. World War II: December 7, 1941 through December 31, 1946.

2.5.1.3. Korean Conflict: June 27, 1950 through January 31, 1955.

2.5.1.4. Vietnam Era: August 5, 1964 through May 7, 1975; for veterans who served "in country" before August 5, 1964 the dates are February 28, 1961 through May 7, 1975.

2.5.1.5. Gulf War: August 2, 1990 through a date to be set by law or Presidential Proclamation

2.5.1.6. There must have been an honorable discharge. Single surviving spouses of such veterans are also eligible.

2.5.1.7. If the claimant is under 65, the applicant must be totally disabled.

2.5.1.8. If the claimant is at least 65, there is no requirement to prove disability. However, the veteran or spouse must be in need of regular aid and attendance due to: Inability of claimant to dress or undress himself/herself, or to keep himself/herself ordinarily clean and presentable; frequent need of adjustment of any special prosthetic or orthopedic appliances which by reason of the particular disability cannot be done without aid (this will not include the adjustment of appliances which normal persons would be unable to adjust without aid, such as supports, belts, lacing at the back etc.); inability to feed himself/herself through loss of coordination of upper extremities or through extreme weakness; inability to attend to the wants of nature; or incapacity, physical or mental, which requires care or

assistance on a regular basis to protect the claimant from hazards or dangers incident to his or her daily environment.

2.5.1.9. Not all of the disabling conditions in the list above are required to exist. It is only necessary that the evidence establish that the veteran or spouse needs "regular" (scheduled and ongoing) aid and attendance from someone else, not that there be a 24-hour need.

2.5.1.10. Determinations of a need for the Veterans Pension is based on medical reports and findings by private physicians or from hospital facilities. Authorization of Veterans Pension benefits is automatic if evidence establishes the claimant is a patient in a nursing home or that the claimant is blind or nearly blind or having severe visual problems.

2.5.2. Income Eligibility.

2.5.2.1. To be able to receive the Veterans Pension benefit, the veteran household cannot have adjusted income (*i.e.*, household income minus unreimbursed medical expenses) exceeding the Maximum Allowable Pension Rate--MAPR -- for that veteran's Pension income category. If the adjusted income exceeds MAPR, there is no benefit. If adjusted income is less than the MAPR, the veteran receives a Pension income that is equal to the difference between MAPR and the household income adjusted for unreimbursed medical expenses. The Pension income is calculated based on 12 months of future household income, but paid monthly.

2.5.2.2. Medical Costs and Long-Term Care Expenses. A special provision for calculating Pension income allows household income to be reduced by 12 months worth of future, recurring medical expenses. Normally, income is only reduced by medical expenses incurred in the month of application. These allowable, annualized medical expenses are such things as health insurance premiums, home care expenses, the cost of paying a family member or other person to provide care, the cost of adult day care, the cost of an assisted living facility, or the cost of a nursing home.

2.5.2.3. This special provision is what allows veteran households earning more than the annual MAPR to qualify for the Veterans Pension Benefit. As an example, a veteran household earning $6,000 a month could still qualify for the Veterans Pension Benefit if the veteran is paying $4,500 to $6,000 a month for nursing home costs. The applicant must submit appropriate evidence for a rating and for recurring costs in order to qualify for this special provision. VA typically does not tell applicants about this special treatment of medical expenses or how to qualify for it.

2.5.2.4. **How is the Benefit Calculated?**

2.5.2.4.1. The monthly award is based on VA totaling 12 months of estimated future income and subtracting from that 12 months of estimated future, recurring and predictable medical expenses. Allowable medical expenses are reduced by a deductible to produce an adjusted medical expense which in turn is subtracted from the estimated 12 months of future income.

2.5.2.4.2. The new income derived from subtracting adjusted medical expenses from income is called "countable" income or IVAP (Income for Veterans Affairs Purposes). This countable income is then subtracted from the Maximum Allowable Pension Rate -- MAPR -- and that result is divided by 12 to determine the monthly income Pension award. This award is paid in addition to the family income that already exists.

2.5.2.5. **Examples of Two Single Veterans in Assisted Living:**

2.5.2.5.1. Both Veterans live in the same Assisted Living Facility and have the same retirement income. The only difference is that one pays $20 more per month for his supplemental health insurance.

Veteran 1: First We Calculate Unreimbursed Monthly Medical Expenses

Assisted Living	$3,500.00
Plus Medicare Part B	$110.50
Plus Medicare Supplemental Medical Insurance	$27.00
Equals Total Monthly Unreimbursed Medical Expenses	$3,637.50
Minus 5% of Maximum Benefit ($1,704)	$85.20
Equals Countable Unreimbursed Monthly Medical Expenses	$3,552.30

Veteran 1: Next We Calculate His IVAP

Total Monthly Income	$3,572.30
Less Countable Unreimbursed Monthly Medical Expenses	$3,552.30
Equals IVAP	$20.00

Veteran 1: Lastly We Calculate His Aid & Attendance Pension Amount

Maximum Annual Pension Rate with Aid & Attendance	$1,704.00
Less IVAP	$20.00
Equals Total VA Pension Benefit per Month	$1,684.00

Veteran 2: First We Calculate Unreimbursed Monthly Medical Expenses

Assisted Living	$3,500.00
Medicare Part B	$110.50
Medicare Supplemental Insurance	$47.00
Total Unreimbursed Monthly Medical Expenses	$3,657.50
Minus 5% of Maximum Benefit ($1,704)	$85.20
Equals Countable Unreimbursed Monthly Medical Expenses	$3,572.30

Veteran 2: Next We Calculate His IVAP

Total Monthly Income	$3,572.30
Less Countable Unreimbursed Medical Expenses	$3,572.30
Equals IVAP	$0.00

Veteran 2: Lastly We Calculate His Aid & Attendance Pension Amount

Maximum Aid & Attendance Benefit	$1,704.00
Less IVAP	$0.00
Equals Total VA Pension Benefit per Month	$1,704.00

2.5.3. Asset Eligibility.

2.5.3.1. **The Asset Test?** There is an asset test to qualify for the Veterans Pension Benefit. Any asset or investment that could be easily converted into income might disqualify the claimant. Theoretically the maximum asset allowance for each applicant is based on an income and age analysis performed by the Department of Veteran Affairs. However, there is no specific dollar amount for the asset test and any amount of assets could block the award. Based on our experience and the experiences of other attorneys around the

country, we recommend that clients reduce their countable assets to less than $10,000 before applying for the Veterans Pension Benefit.

2.5.3.2. **Asset Exemptions:** For purpose of the for the Veterans Pension Benefit, the primary residence (even if the client is no longer living in it, but so long as it is not rented) is generally excluded from the asset test. However, it is important to remember that the home is not necessarily an exempt asset for purposes of Medicaid eligibility. One vehicle is also generally excluded from the asset test.

2.5.3.3. **Asset Transfers:** For purpose of the for the Veterans Pension Benefit, assets may be transferred or converted to income in order to meet the asset test. Unlike Medicaid, there is generally no look-back period or transfer penalty for transferring assets **prior to applying** for the Veterans Pension benefit. However, the VA does apply the equivalent of a transfer penalty if assets are transferred after applying for Aid and Attendance. Also, because the veteran or the surviving spouse might need to apply for Medicaid in the future, it is extremely important to consider future Medicaid eligibility when transferring assets or converting assets to income in order to obtain eligibility for the Veterans Pension benefit.

2.6. Filing a Claim

2.6.1. Complexity.

2.6.1.1. Filing a claim for the Veterans Pension Benefit is complex and time-consuming. If you want to do it correctly, it's important to get qualified assistance. Just knowing which form to fill out and how to complete it is a complex endeavor in itself. Even if the proper form is completed, failure to check a single box may result in a complete denial of your claim.

2.6.1.2. The application process involves: obtaining evidence of prospective, recurring medical expenses; appointments for VA powers of attorney and fiduciaries; and a thorough understanding of the application process. Often, qualification for this benefit involves reallocation of assets and shifting of income in order to qualify, and these reallocations may have significant impact on Medicaid eligibility.

2.6.1.3. Given that many veterans who need the Veterans Pension Benefit will most likely also need Medicaid in the future, this process should not be attempted without the help of an experienced elder law attorney who thoroughly understands both the Veterans Pension Benefit and the Medicaid program, as well as the interaction between these two benefit

programs.

2.7. Using Trusts for Aid and Attendance.

2.7.1. Reducing Countable Assets.

2.7.1.1. It is a common planning practice for a veteran seeking to reduce countable assets to transfer assets to a properly-drafted irrevocable trust in a sufficient amount to reduce the veteran's assets before submitting an application for the Veteran's Aid and Attendance special pension benefit.

2.7.1.2. Not all irrevocable trusts, however, will allow the claimant to qualify for benefits. In fact, most irrevocable trusts, including the Income Only Asset Protection Trust, do not work for Veteran's Asset Protection Planning.

2.7.1.3. Opinions from the VA counsel's offices make it clear that transfers of property to "special needs" trusts for the benefit of the veteran, particularly where the veteran is trustee, or other arrangements where the veteran retains any kind of "life estate" or "life interest" in the transferred property, will not result in the exclusion of the transferred property from the calculation of the veteran's net worth for purposes of the Aid and Attendance benefits.

2.7.1.4. As noted in a 1997 VA Regional Counsel opinion:

> 2.7.1.4.1. "[P]roperty and income from property may be countable as belonging to a claimant if the claimant possesses such control over the property that the claimant may direct that it be used for the claimant's benefit. Such control may be considered a sufficient ownership interest to bring the property within the scope of the pension laws. It follows that…property over which a claimant, or someone with legal authority to act on the claimant's behalf, has some control to use for the claimant's benefit can reasonably be expected to be consumed for a claimant's maintenance and thus be includable in the claimant's estate."

2.8. Tax Goals When Using Trusts for Aid and Attendance.

2.8.1. Keeping it a Grantor Trust.

2.8.1.1. The vast majority of Veterans who are attempting to get the Aid and Attendance benefit are middle class Americans who have estates that are not likely to be subject to Federal Estate Tax, so the goal in estate planning for these clients, just as with Medicaid Planning clients, is to create a trust that is a Grantor Trust for both income and Estate Tax purposes.

2.8.2. Grantor Trust for Income Tax Purposes.

2.8.2.1. An Irrevocable Trust can be made a "grantor trust" for income tax purposes by choosing one of the grantor trust powers that creates grantor trust status over income. The primary powers used for this purpose are:

2.8.2.1.1. the power to receive income – this power is used in the LTPs, but NOT in Veterans Trust;

2.8.2.1.2. the power to substitute assets of equal value – this power is NOT used in LTP or the Veterans Trust as Medicaid and VA might construe this power as having "access" to principal;

2.8.2.1.3. the power to change beneficiaries (i.e., limited Power of Appointment) – used in LTP and Veterans Trust.

2.8.3. Grantor Trust for Estate Tax Purposes (i.e., Estate Inclusion).

2.8.3.1. Two of the above powers over income -- the power to substitute assets and the power to change beneficiaries -- **also** provide Grantor Trust status over trust **principal**, so using these powers makes transfers to the trust an incomplete for gift for estate tax purposes, thus includable in the grantor's estate, which also allows for the step-up in basis.

2.8.3.2. However, we already know that the power to substitute assets of equal value can not be used in an LTP or the Veterans Trust because Medicaid and VA might construe this power as having "access" to principal.

2.8.3.3. Accordingly, the power to change beneficiaries is the only power that can safely be put into the Veteran's Trust that will achieve the desired goal of Estate Inclusion.

2.9. Trustee Considerations.

2.9.1. Can Settlor Serve as Trustee for a Veterans Trust?

2.9.1.1. Although the Settlor to act as trustee of an income-only trust for Medicaid purposes, the Settlor should not act as the trustee of a trust designed for Veterans Asset Protection.

2.9.1.2. The VA's warning that "[P]roperty and income from property may be countable as belonging to a claimant if the claimant possesses such control

over the property that the claimant may direct that it be used for the claimant's benefit" means that allowing a Settlor to act as Trustee would most likely be considered as allowing the Settlor to have control over the property, therefore rendering it countable.

2.9.2. Can Settlor Can Remove or Replace Trustee.

2.9.2.1. The same logic applies as above – giving this power to the Settlor would most likely be considered allowing the Settlor to have control over the property, therefore rendering it countable.

SECTION 3. PRACTICE TOOLS.

3.1. Evan Farr's Living Trust Plus™ Asset Protection System.

3.1.1. http://www.LivingTrustPlus.com

3.2. MPS™

3.2.1. http://www.mpssuccess.com

3.3. ElderDocx™

3.3.1. http://www.eldercounsel.com

3.4. Interactive Legal Elder Law & Special Needs Planning Suite™

3.4.1. http://www.interactivelegal.com