TRUSTS FOR VETERANS ASSET PROTECTION PLANNING

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Evan Farr is also the creator of the Living Trust Plus® Medicaid Asset Protect Trust and the Living Trust Plus® Veterans Asset Protect Trust, which has direct application to many of the planning considerations and Veterans Asset Protection Trust issues discussed in this article. For more information, please contact that author at evanfarr@farrlawfirm.com.

BASIC OVERVIEW OF VETERANS ASSET PROTECTION PLANNING: PURPOSE

The purpose of veterans asset protection planning is to protect a wartime veteran's assets in order to qualify the veteran to receive the Veterans 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 Veterans Aid and Attendance special pension benefit has its own complex financial requirements that must be met. 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.

United States Code

Title 38 of the United States Code (U.S.C.) applies to veterans benefits. Other U.S.C. Titles have a bearing on veterans benefits as well, such as Title 5, which concerns government organization and employees, and Title 10, which pertains to the military.

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. 38 U.S.C. § 501.

Code of Federal Regulations

The Secretary's rules and regulations are contained in Title 38 of the Code of Federal Regulations (38 C.F.R.). 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.

Directives and Records

Directives provide instructions to Veterans Administration (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).

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.

Veterans Aid and Attendance

The VA pays for long-term care primarily through its "Aid and Attendance" payments, which is actually a Veterans special pension with an add-on for Aid and Attendance. On January 23, 2015, proposed rule changes to amend the veterans pension application process were published by the VA in the Federal Register. These new rules went into effect October 18, 2018. The new rule changes have a significant effect on elder care planning for veterans, making asset protection trusts for veterans the primary planning tool, using the three-year look-back period. The new rules mirror Medicaid rules in some ways, as they require a net worth determination and a look-back period, and impose penalties for asset transfers. Below is a brief summary of the key proposals that went into effect on October 18, 2018.

Net Worth

The new rule imposes a net worth limit similar to the maximum community spouse resource allowance for Medicaid purposes, but it rises using a different rate of inflation. The net worth bright-line limit effective December 1, 2018 is $127,061. "Net worth," despite what it means to the rest of the world, is determined by combining assets and annual income. A veteran's assets are defined to include both the assets of the veteran and the assets of his or her spouse. A surviving spouse's assets would only include the assets of that surviving spouse. The calculation of net worth is as follows:

> All Countable Assets + (Annual Gross Income - net Unreimbursed Medical Expenses).

Note that countable assets include assets of veteran as well as the assets of the spouse. See 38 C.F.R. § 3.275 for criteria for evaluating net worth.

Look-back on Asset Transfers

Under old VA rules, there was no transfer penalty. This meant that your clients could transfer excess assets and apply for VA benefits the next day. New Reg. § 3.276(e) now imposes a look-back and transfer penalties. The new rules establish a three-year look-back period for asset transfers for less than fair market value; Medicaid has a five-year look back period. The penalty period will be calculated based on the total assets transferred during the look-back period to the extent they would have exceeded a new net worth limit that the rules also establish.

Exempt Assets — The Home?

Under the new rules, the primary residence along with a lot size up to two acres (regardless of value), is exempt. Under the old rules, a residence and underlying/surrounding land "similar in size to other residential lots in the vicinity" were not countable. If most residences in the area were on 20 acres, for example, the applicant's residence and surrounding land would not be countable.

The new two-acre limit applies "unless the additional acreage is not marketable." The examples given with regard to nonmarketable acreage related to acreage "only slightly more than 2 acres," property that might be inaccessible (surrounded by other owners, perhaps) or property subject to zoning limits that could prevent a sale. It is unknown what other factors might make additional acreage "not marketable."

Example: Under the old rules, your client lives in his rural home on 12 acres of land, not uncommon for his county, where most people have lots of between 10 and 50 acres. Under the new rules, your client likely has 12 acres of countable real estate. Unless zoning laws or other "marketability issues" prohibit it, your client would most likely have to subdivide his property so that his lot is only two acres. This process, or course, could take several years, so it will, in almost all cases, be simpler to simply transfer the entire house and land into trust and wait out the three-year lookback.

It is important to note that the house is not an exempt asset for Medicaid in Virginia, and in most states where it is "exempt" in connection with Medicaid, it is not truly protected because of Estate Recovery "clawback," so houses must still be protected because anyone who is in need of Veterans Aid and Attendance will most likely, at some point in the future, be in need of Medicaid.

Once the primary residence is sold, the residence is no longer exempt because it has been converted to money, and that money will be countable as of January 1 of the year following the year of sale. Another reason that houses need to be protected, preferably by a properly structured Veterans Asset Protection Trust, prior to being sold.

Other exempt assets include:

- Family transportation vehicles and personal items used on a regular basis. Note: Multiple vehicles are excluded so long as they are used for the veteran on a regular basis; not so with Medicaid, which exempts only one vehicle;
- Pre-paid burials and burial plots;
- Any asset that was transferred or gifted prior to October 18, 2018.

Penalty Period

Under the new regulations, veterans or their surviving spouse who transfer assets within three years of applying for benefits is subject to a penalty period that can last up to five years. There is a complex calculation to determine the penalty period. Rule 3.276(e)(1) uses a single divisor for all claimants, which results in equal penalty periods for equal amounts of precluded asset transfers regardless of the type of claimant. The single divisor is the maximum annual pension rate (MAPR) in effect on the date of the pension claim at the aid and attendance level for a veteran with one dependent, currently $26,766 per year, or $2,230 per month. This means that when an applicant has transferred assets within the three-year look back period, the total of gifted assets is divided by $2,230.

For example, assume the current net worth limit of $127,061 and an applicant has a net worth of $115,000. The applicant transferred $30,000 to a child during the look-back period. If the applicant had not transferred the $30,000, his net worth would have been $145,000, which exceeds the net worth limit by $17,939. The penalty period will therefore be calculated based on $17,939, the amount the applicant transferred that put his assets over the net worth limit ($145,000-$127,061). The transfer subject to penalty would be divided by the 2019 MAPR of $2,230, resulting in a 8.04 month penalty ($17,939 divided by $2,230 = 8.04). The penalty begins to run on the first day of the month following the month of transfer.

A penalized transfer may be cured in whole or partially, provided that it is done within 60 days of the notice of penalty and evidence of cure is received by the VA no later than 90 days from the date of notice.

- Only transfers of countable assets are penalized. Transfers of exempt (non-countable) assets are not penalized.
- Transfers are only penalized if they adversely affect Net Worth (i.e., if the transfer reduces net worth to less than $127,061).
- Transfers to set up a SNT for a dependent child who was disabled before the age of 18 are not penalized.
- There are exceptions to the penalty period for fraudulent transfers and for transfers to a trust for a child who is unable to provide "self-support."

Annual Gross Income

Annual gross income includes "all income from sources such as wages, salaries, earnings, bonuses, income from business, profession, investments and rents."

- Income of spouse is also included.
- Waived income is also included in annual gross income computation.
- There is an exception for withdrawing a Social Security application after finding of entitlement to Social Security benefits.

See 38 C.F.R. § 3.262 (how income is evaluated); 38 C.F.R. § 3.271 (computation of income; 38 C.F.R. § 3.272 (exclusions from income). Gross income shall be counted during the 12-month annualization period in which received.

Unreimbursed Medical Expenses

Unreimbursed medical expenses encompass any amounts paid within the 12-month annualization period regardless of when the indebtedness was incurred. See 38 C.F.R. § 3.278 for definition of what constitutes a medical expense.

Medical Expense Deductions from Income

Medical expenses are those that are either medically necessary or improve a disabled individual's functioning. These medical expenses are deducted from income. This becomes more complicated when the claimant is receiving home care or is in an independent or assisted living facility, as the new rules somewhat limit the circumstances under which room and board expenses may be counted, as well as the amount paid. There are very specific rules as to which services qualify as medical expenses and the claimant will have to be able to identify those in his or her application. Section 3.278 (d)(3)(i)(B) now provides, in final paragraph (d)(3)(iv), that payments for meals and lodging, as well as payments for other facility expenses not directly related to health or custodial care, are medical expenses when either of the following are true: (1) the facility provides or contracts for health care or custodial care for the disabled individual; or (2) a physician, physician assistant, certified nurse practitioner, or clinical nurse specialist states in writing that the individual must reside in the facility (or a similar facility) to separately contract with a third-party provider to receive health care or custodial care or to receive (paid or unpaid) health care or custodial care from family or friends.

The proposed limited the hourly amount that can be paid to a home health care provider and based the amount on a national average, rather than local costs for care. The final rule does not include a limit to the hourly rate of in-home care. Any veterans trust established before the effective date of the new regulations will, hopefully, not be subject to the new rules.

Veterans "Half-Loaf" Asset Protection Planning Under the New Rules

The fact that the penalty period begins the first day of the month that follows the last asset transfer makes this new law similar to the old Medicaid gifting rules that were in effect prior to the Deficit Reduction Act of 2005 (DRA).

Under prior Medicaid law, someone already in a nursing home wanting to apply for Medicaid could give away half of his or her spend-down amount, immediately commencing the penalty period, and the nursing home resident would simply retain the other half to privately pay throughout the penalty period associated with the gift (as opposed to the Medicaid law since DRA, which says that the penalty period doesn't start until someone has applied for Medicaid and is otherwise eligible "but for" the penalty period). This old Medicaid gifting strategy will now be available in connection with applications for the veteran's pension. Below is an example of how this strategy works.

Let's take John Jones, a single veteran. The net worth limit is $127,061. Mr. Jones has assets of $200,000 and annual income from Social Security of $24,000 ($2,000 per month) from Social Security. Adding his annual income to his assets produces a "net worth" of $224,000, which exceeds the net worth limit by $96,939, meaning that he has $96,939 in assets to be

protected. Let's further assume that he lives in an Assisted Living Facility and his monthly cost of care is $6,000. Based on these assumptions, we can calculate his monthly shortfall as follows:

Assisted Living Facility Monthly Cost	$6,000
Minus Monthly Income	– $2,000
Equals Monthly Assisted Living Shortfall	$4,000

Now that we know his monthly shortfall, we can calculate how much of his assets can be transferred to the applicant's children using the half-loaf strategy and how much must be retained and spent on Assisted Living Expenses to cover his monthly shortfall during the penalty period.

$4,000.00	Monthly Assisted Living Shortfall		Penalty & Payout Period
$96,939	Assets to be protected		
$34,900.00	<= Amount to be Transferred to Children	Number of Resulting Penalty Months, rounded down =>	16
$62,039.00	<= Amount to be Retained and Paid to ALF	Number of months that can be paid to ALF using the retained amount. =>	16

Result: After 16 months, $34,900 out of the $96,939 in unprotected funds has been protected under the control of Mr. Jones' children, in addition to the $127,061 net worth limit that Mr. Jones is allowed to keep, and Mr. Jones can now apply for Aid and Attendance and begin receiving his VA pension amount of $22,577 per year / $1,881 per month. The net result is that Mr. Jones and his children get to keep $161,961 out of the $224,000 "net worth" he started with.

FILING A VETERANS PENSION CLAIM

Complexity

Filing a claim for the Veterans Pension Benefit is complex and time-consuming. If you want to do it correctly, it is 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.

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.

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.

Using Trusts for Aid and Attendance; Reducing Countable Assets

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 at least three years before submitting an application for the Veterans Aid and Attendance special pension benefit.

Not all irrevocable trusts, however, will allow the claimant to qualify for benefits. In fact, most irrevocable trusts do not work for veterans asset protection planning. 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.

As noted in a 1997 VA Office of General Counsel opinion:

> [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 only 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.

See VAOPGCPREC 33-97, 1997, page 4, citing VAOPGCPREC 15-92 (1992) and VAOPGCPREC 72-90 (1990).

Can Settlor Serve as Trustee for a Veterans Trust?

Although the settlor can absolutely act as trustee of a Veterans Asset Protection Trust for Medicaid purposes, many attorneys believe that the settlor should not act as the trustee of a trust designed for veterans asset protection.

The VA's warning is 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." 90 VAOPGCPREC 33-97, 1997, page 4, citing VAOPGCPREC 15-92 (1992) and VAOPGCPREC 72-90 (1990).

Accordingly, so long as the assets in the trust cannot be used the for the claimant's benefit, there is no legal problem in having the claimant serve as trustee, unless the beneficiaries of the trust are residing in the veteran's household, in which case the VA could attribute indirect benefit to the veteran of distributions to the beneficiaries.

The ability of the claimant to serve as trustee is directly addressed by VAOPGCPREC 73-91, which presented the following two questions:

- Would proceeds from a life-insurance policy received by a veteran and shares of stock inherited by a veteran, which are placed into a valid irrevocable trust for the benefit of the veteran's grandchildren with the veteran as trustee, be counted as income of the veteran for purposes of determining entitlement to improved-pension benefits?
- Would these assets be considered in determining the veteran's net worth for improved-pension purposes?

In answering these questions, the VA Office of General Counsel stated as follows:

> We consider that principle legally sound on the basis that, as explained by the Assistant General Counsel in Undigested Opinion, 2-5-63 (Veteran), only property over which the veteran has some control to use for the veteran's own benefit can reasonably be expected to be consumed for the veteran's maintenance per 38 U.S.C. section 1522.

Under the circumstances described, the veteran in an individual capacity, as distinguished from a fiduciary capacity, would have no legal ownership of the property and no authority or right to use, control, or dispose of the property or the income therefrom for the veteran's own benefit after the proposed transfer. Under these circumstances, subject to the following discussion, the trust assets would not be considered a part of the veteran's estate. Further, income derived by the trust from trust assets would not be counted as income of the veteran for pension purposes. See O.G.C. Prec. 72-90 (1990).

In answering these questions, the VA Office of General Counsel held as follows:

> Generally, where a veteran places assets into a valid irrevocable trust for the benefit of the veteran's grandchildren, with the veteran named as trustee, and where the veteran, in an individual

> capacity, has retained no right or interest in the property or the income therefrom and cannot exert control over these assets for the veteran's own benefit, the trust assets would not be counted in determining the veteran's net worth for improved-pension purposes, and trust income would not be considered income of the veteran.
>
> [However,] [i]f the beneficiaries of the trust are residing in the veteran's household and the veteran is receiving benefit from expenditures from the trust, a determination must be made under the facts of the particular case whether the veteran is exercising such control and use of the trust assets that the trust may be considered invalid for purposes of determining pension eligibility.

TAXATION OF THE VETERANS ASSET PROTECTION TRUST

Income Tax

Internal Revenue Code section 678(a) states that "A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself." The Veterans Asset Protection Trust should allow the trust beneficiaries to demand all trust income each year, thus making the trust a grantor trust to the beneficiaries as to the income, which is the result we want because want all trust income to be taxable to the beneficiaries whether distributed to them or not.

This way, no income will be retained by the trust and reported to the grantor on an annual Grantor Trust Statement and no ordinary income from the trust will flow through to the Grantor's 1040. This could be important for some clients because the VA does something each year called an income verification match (IVM). If the trust income is reported on the Grantor's 1040, the VA might consider this to be the Grantor's income (which could affect the amount of the Aid and Attendance benefit the veteran receives), even though the Grantor never actually receives the income.

The Settlor retains a testamentary power of appointment to distribute corpus, thereby allowing the assets remaining in Trust to be included as part of Settlor's gross taxable estate. The ability of the Settlor to change beneficiaries (i.e. who receives the trust corpus upon the Settlor's death) makes this a Grantor Trust as to the Settlor as to the trust corpus (I.R.C. § 674(a) and Treas. Regs. § 1.674(d)-2(b)). Pursuant to I.R.C. § 674(a), "The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party." Estate inclusion is brought about by I.R.C. section 2038, which applies to "revocable transfers." The settlor's retained power to change beneficiaries makes the designation of beneficiaries "revocable" within the meaning of section 2038, although the trust is irrevocable. If the assets of the Trust are included in the Grantor's estate, then the beneficiaries of the Trust receive a step up in basis under I.R.C. section 1014(b)(10), also a desired result.

The Settlor of a veterans trust does not have the right to change beneficiaries during lifetime because that may be seen by the IRS as giving Settlor control over who receives the trust income, thus making this trust not a grantor trust as the beneficiaries, which could interfere with the ability to get Veterans Aid and Attendance in the future because of trust income possibly being deemed to belong to the Settlor.

Pursuant to IRS Form 1041 Instructions, generally if a trust is treated as owned by two or more grantors or other persons, the trustee may choose Optional Method 3 as the trust's method of reporting instead of filing Form 1041. Optional Method 3 states that for a trust treated as owned by two or more grantors or other persons, the trustee must give all payers of income during the tax year the name, address, and Taxpayer Information Number (TIN) of the trust. The trustee also must file with the IRS the appropriate Forms 1099 to report the income or gross proceeds paid to the trust by all payers during the tax year attributable to the part of the trust treated as owned by each grantor, or other person, showing the trust as

the payer and each grantor, or other person treated as owner of the trust, as the payee. The trustee must report each type of income in the aggregate and each item of gross proceeds separately.

Income Tax Reporting

A separate taxpayer identification number is not required and a separate tax return (Form 1041) need not be filed by the trustee—just the appropriate 1099s for all trust income.

Gift Tax

If a Veterans Asset Protection Trust should be designed so that the settlors retain a limited power of appointment in the trust corpus and can force the trustee to distribute corpus to beneficiaries at any time, transfers to the Veterans Asset Protection Trust are not considered completed gifts for gift tax purposes, because 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. Treas. Reg. § 25.2511-2(b).

Gift Tax Reporting

Even though the transfer of assets into the trust is not considered a taxable gift, pursuant to Treas. Reg. section 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.[1] 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. Treas. Reg § 25.6019-3. 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 there should be no penalty for failure to file. Nevertheless, a gift tax return should be filed pursuant to Treas. Reg section 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.

Neither Treas. Reg section 25.6019-3 nor the IRS Form 709 Instructions reveal how to report an incomplete gift. However, Treas. Reg section 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."

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.

Estate Tax

If the Veterans Asset Protection Trust is designed so that the settlors retain a limited power of appointment in the trust corpus and can force the trustee to distribute corpus to beneficiaries at any time, transfers to this Living are included as part of Settlor's

gross taxable estate pursuant to I.R.C. sections 2036(a)(2)[2] and 2038.[3]

Step Up in Basis

If the Veterans Asset Protection 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. See also I.R.C. § 1014(b)(3), Treas. Reg. §§ 1.1014-2(a)(3), 1.1014-2(b).

Capital Gains Exclusion for Sale of Principal Residence

If the Grantor is considered the owner of the entire Trust (including the residence) under the Grantor Trust rules (I.R.C. §§ 671-679), the taxpayer will be treated as the owner of the residence for purposes of satisfying the ownership requirements of I.R.C. section 121.

Accordingly, by transferring a residence to a separate "Residence Trust," one where the Settlor retains Grantor Trust powers over the entire trust—both income and principal—because the settlor retains the right to receive income and/or a limited lifetime and testamentary power of appointment, the exclusion from capital gains on the sale of a principal residence is maintained.

The Self-Settled Trust: A Source of Confusion[4]

The plain meaning of the term "self-settled trust" is a trust established by a settlors 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 settlors can derive any benefit.

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

Under traditional trust law, this type of "self-settled trust" has never been effective for asset protection purposes because, 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.

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

Clearing Up the Confusion about "Self-Settled" Trusts

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.

Fraudulent Transfers

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

UFTA

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.

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." 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.

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 discovers a transfer to a Veterans Asset Protection Trust 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.

BAPCPA

On April 20, 2005, 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."

See 11 U.S.C. § 548(e)(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 10 years. Similarly, the operative language "actual intent to hinder, delay, or defraud" is identical to the language used in the UFTA. [5]

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 10-year limitations period instead of four years plus a one-year discovery period.[6]

The consequence of this amendment is that it now provides a uniform fraudulent transfer remedy in all 50 states. The 2005 Bankruptcy Act does not change the effectiveness of a Veterans Asset Protection Trust that is properly used for asset protection, i.e., established and funded while a client is essentially free from financial difficulties.[7]

Fraudulent Transfers as to Future Creditors

Transfers to asset protection trusts 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 section 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).

Although this definition appears to encompass virtually any creditor, case law has narrowly defined "future creditor."[8] 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.[9] 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.[10]

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.[11]

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.[12]

One important question is whether the Bankruptcy Code provisions (including the 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.[13]

Notes

1 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."

2 I.R.C. section 2036(a)(2) states in relevant part that 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…(2) the right…to designate the persons who shall possess or enjoy the property or the income therefrom."

3 I.R.C. section 2038 states in relevant part that "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…by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power . . . ."

4 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.

5 Shaftel and Bundy, Impact of Domestic Asset Protection Trusts and the Bankruptcy Challenge, available at http://shaftellaw.com/docs/article_23_pt2.pdf

6 Id.

7 Id.

8 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).

9 Id. at ¶ 6.09[1].

10 Id. at ¶ 3.03[4][a].

11 Id., citing G. Glenn, Fraudulent Conveyances and Preferences § 319, at 557 (rev. ed. 1940).

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

13 Id.