

THE PRACTICAL ESTATE PLANNER



In practice since 1987, Certified Elder Law Attorney **EVAN FARR** is widely recognized as one of the leading Elder Law, Estate Planning, and Specials Needs attorneys in Virginia, Maryland, and the District of Columbia, and one of foremost experts in the country in the field of Medicaid asset protection and related trusts. He 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.

Evan has also 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 five percent of Elder Law and Estate Planning attorneys in Virginia every year since 2007, and in the Washington, D.C. 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. Evan is a nationally renowned 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 numerous national legal organizations such as the National Academy of Elder Law Attorneys, ALI CLE, the National Constitution Center, myLaw CLE, the National Business Institute, the Virginia Academy of Elder Law Attorneys, the Virginia Bar Association, Virginia Continuing Legal Education, and the District of Columbia Bar Association.

USING IRREVOCABLE TRUSTS FOR MEDICAID ASSET PROTECTION AND GENERAL ASSET PROTECTION (PART 1)

There is no reason for any middle-class American desiring to create an asset protection trust to go outside of their home state to do it. Residents of almost all states may create a “Living Trust Plus” asset protection trust to protect their assets from probate lawsuits and protect Medicaid, Veterans’ Aid, and Attendance benefits.¹ With a standard Living Trust Plus, the settlor retains the right to receive the trust income, but does not retain the right to access the corpus/principal of the trust. Because of the way this trust functions, it is sometimes referred to as an “income-only trust.” However, most so-called income-only trusts are drafted improperly, and those shortcomings are addressed by the Living Trust. Principal of the Living Trust Plus can be retained in the trust or distributed to beneficiaries other than the settlor or the settlor’s spouse. After the settlor’s death, a Living Trust Plus may terminate or may continue with income payable to the settlor’s spouse, and corpus distributed to or held in further trust for the benefit of the remainder beneficiaries, typically the settlor’s children.

In addition to the “income-only” version, there are two other versions of the Living Trust Plus Asset Protection Trust. The most commonly used version is what the author calls the Living Trust Plus Total Protection Trust, which protects income and principal by not allowing the trust to distribute income to the trust settlor. This version offers greater protection and greater simplicity in managing the trust, since there is no need to separately account for and distribute trust income. The third version is what the author calls the Living Trust Plus Veterans Trust, which is a grantor trust *as to the beneficiaries of the trust* because it gives the beneficiaries the right to demand all trust income from the trust, which in turn causes the beneficiaries to be taxed on all trust income. See this author’s article entitled “Trusts for Veterans’ Asset Protection Planning” published in the August 2019 issue of *The Practical Lawyer*. If the client still owns a primary residence with unrealized capital gain, the Veterans’ version of the trust is often accompanied by a Living Trust Plus Total Protection Trust to protect the residence and to enable the sale of the residence to qualify for the Internal Revenue Code (“Code”) section 121 capital gains exclusion and to qualify for a step-up in basis upon the Settlor’s death.

For middle-class Americans, the Living Trust Plus is the preferable form of asset protection trust because, for purposes of Medicaid eligibility, the Living Trust Plus type of trust 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 corpus of a trust, then the entire balance of the trust is a countable resource.

The settlor of the Living Trust Plus (except for the Veterans Version) can serve as the Trustee, which is an important consideration for many persons wanting to establish an asset protection trust.

Middle class Americans seeking asset protection cannot 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 average Americans are likely to face in their lifetimes.

HOW THE LIVING TRUST PLUS WORKS FOR MEDICAID ASSET PROTECTION

A detailed understanding of Medicaid rules and Medicaid Asset Protection strategies is beyond the scope of this article. However, a very basic understanding of the Medicaid look-back period and transfer penalty rules is essential to an understanding of the use of and importance of the Living Trust Plus.

Look-Back Period

For Medicaid eligibility purposes, since February 8, 2006, there has been a five-year look-back period for uncompensated transfers.² This means that on an application for Medicaid benefits, there is a question asking whether the applicant or the applicant's spouse has made any uncompensated transfers made to an individual or to a trust within the previous five years. All such transfers must be disclosed to Medicaid, and failure to do so constitutes Medicaid Fraud, which is a criminal offense.

Transfer Penalty

Any uncompensated transfer of assets made within the five-year look-back 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 five years.

Example 1

Joe transfers \$500,000 to a Living Trust Plus in January of 2019, and then enters a nursing home and applies for Medicaid in December of 2024. The penalty divisor for Joe's state is \$7,000. Joe is eligible for Medicaid but for the uncompensated transfer. By applying for Medicaid before the expiration of the five-year look-back period, Joe must report the \$500,000 uncompensated transfer, which results in a penalty period of over 71 months (almost six years) and that 71-month penalty period starts in December 2024, when Joe applied for Medicaid, which was already almost five years from the date of funding the trust, meaning no eligibility for Medicaid for approximately 12 years after funding the trust.

Example 2

Same facts, except Joe waits to apply for Medicaid until March of 2024. By applying for Medicaid after the expiration of the five-year look-back 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, having waited only for the expiration of the five-year look-back period.

PURPOSE OF USING THE LIVING TRUST PLUS INCOME-ONLY TRUST

Asset Protection

The Living Trust Plus is 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. Such transfers, whether to a Living Trust Plus or directly to a child, are subject to the Medicaid five-year look-back period.

Independence

Transferring assets to a Living Trust Plus allows the settlor to maintain greater financial independence than a direct gift to children. When real estate is transferred to a Living Trust Plus, the trust should enter into an occupancy agreement with the settlor so that the settlor retains the right to live in the real estate or receive the rental income from any rental property. Sometimes a life estate should be preserved, especially if ownership of the life estate will allow the client to become or remain eligible for senior citizen real property tax relief.

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. Transfer to a Living Trust Plus avoids all of these risks.

Statutory Authorization

The Living Trust Plus Income-Only Trust is permitted under the federal Medicaid law (OBRA '93), 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 to the individual could be made

shall be considered resources available to the individual.³

Under Medicaid law, 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,⁴ 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.⁵

The Living Trust Plus Income-Only Trust is 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.⁶

However, neither OBRA '93 nor the CMS State Medicaid Manual fully explain how or why irrevocable incomeonly trusts work, because the language of OBRA '93 and the CMS State Medicaid Manual is ambiguous. What did Congress mean when it wrote in OBRA '93 that "[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?" Does this mean that because the corpus is what generates the income, that the entire corpus is countable because the income can be distributed to the Trust Settlor? No, that is not what Congress or CMS intended, and this was fully and clearly explained via two letters—the Streimer letter and the Richardson letter—written by the then-heads of HCFA, the predecessor agency to CMS. The Streimer and Richardson letters, taken together, contain the full interpretation of OBRA '93 and, together with OBRA '93, still stand as the federal law governing irrevocable incomeonly trusts.

Under the Richardson letter, dated December 23, 1993⁷:

- 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 look-back.

This left open the issue of whether a look-back 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.⁸ HCFA finally clarified the rules in a letter dated February 25, 1998.⁹

The Streimer letter referenced above,¹⁰ clarified the rules by stating as follows:

[For transfers to an income-only trust]: 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 five-year look-back period.

[For transfers from an income-only trust]: [W]here assets in a trust cannot 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.

The above statute and letters apply to an income-only trust; however, they of course also apply to the more common Living Trust Plus version where the settlors don’t retain any rights to receive income or principal.

Administrative Actions Presumed Correct

The Richardson letter and the Streimer letter referenced above are administrative actions and therefore presumed to be accurate statements of the law because they constitute administrative action taken by a federal administrative agency. It is presumed that all administrative actions are made in accordance with statutory provisions:

The management of the Medicaid laws is committed to the executive branch of government through duly designated officials charged with administering the Medicaid program B, in this case HCFA (now CMS). Judgments of administrative officials are entitled to be regarded by the courts as presumptively correct....¹¹ Moreover, an agency’s expertise and experience only strengthens the presumption taken in its favor.¹²

Corpus Distribution Provisions

There can be absolutely no access to corpus by either the settlor or the settlor’s spouse. If either spouse has direct access to corpus/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.

The Living Trust Plus is 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.” Through this mechanism, the beneficiaries could also, if they choose, make distributions of what was trust corpus/principal back to the settlor or for the benefit of the settlor.

The disadvantage of distributing the assets from the Living Trust Plus is that the opportunity for a step-up in basis will be lost.

It is essential, 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.

Care should 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. This can be avoided by requiring a trust protector or independent trustee to acquiesce in any transfers to the trustee.

Can an Irrevocable Trust Be Terminated?

Although the Living Trust Plus is, by definition, irrevocable, it is important to understand that an “irrevocable” trust is simply a trust that cannot be revoked unilaterally by the settlor. Under common law and under the Uniform Trust Code, 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.

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 terminated upon consent of the settlor and all trust beneficiaries.

Accordingly, the Living Trust Plus can be terminated, and the assets returned to the settlor, if the settlor and all trust beneficiaries agree to the termination.

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.

Can the Settlor Serve as Trustee?

The most common question asked by clients wanting to establish a Living Trust Plus is whether they, as the settlor of the trust, can also act as the trustee of the trust. Although many commentators and attorneys in private practice take the position that a settlor cannot serve as the Trustee of an irrevocable trust established by the settlor, there is no legal support for this conclusion in connection with a properly drafted income-only trust. It may be better from a practical standpoint for the settlor to not serve as trustee, but there is no legal prohibition against the settlor so serving.

Trustee as a Fiduciary

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. 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 in the Living Trust Plus Income Only Trust, 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. If the settlor retains no income interest, then the entire corpus is vested in the beneficiaries, and creditors therefore should not be able to reach any assets in the trust.

This immediate vesting in the remainder beneficiaries is an important feature of a properly drafted Living Trust Plus, because without immediate vesting in remainder beneficiaries no one would have the right to enforce the terms of the trust, which would render the trust analogous to a revocable trust and would therefore provide no asset protection to the settlor.

Just as a settlor can serve as the trustee of his own Living Trust Plus, so can the settlor retain the right to remove and replace someone else acting as trustee of the settlor’s Living Trust Plus. The same logic applies.

Avoiding Confusion

Consider giving the settlor of the Living Trust Plus the right to remove and replace trustees. 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 an “incident of ownership” over the life insurance policy, thereby bringing the policy proceeds into the settlor’s gross estate pursuant to Code section 2042, which would defeat the purpose of the irrevocable life insurance trust.

With the Living Trust Plus, 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.

In Part 2 of this series, we will examine the relevant case law surrounding these types of trusts. 📌

Notes

- 1 The Living Trust Plus® Asset Protection Trust is the trademarked name for the author’s proprietary asset protection trust drafting and marketing system, which the author licenses to attorneys throughout the country (except for Minnesota, where Medicaid asset protection trusts don’t work). See <https://livingtrustplus.com>. This article is not meant to endorse the author’s Living Trust Plus Asset Protection Trust Drafting and Marketing System, and there are other drafting systems that produce Medicaid asset protection trusts, such as Elder Counsel and Interactive Legal Systems, and practitioners can of course draft their own trusts. The author uses his trademarked name Living Trust Plus in this article because the author believes the name is more descriptive than calling it merely a “Medicaid Asset Protection Trust.”
- 2 Prior to the enactment of the federal Deficit Reduction Act of 2005 (DRA), Pub. L. No. 109171, the look-back period was three years for outright transfers and five 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 IncomeOnly Trust in Medicaid Planning,” available at <https://www.spsk.com/018EE5/assets/files/News/Whitenack-Jan09.pdf>.
- 3 42 U.S.C. § 1396p(d)(3)(B).
- 4 The creation and funding of a testamentary trust is not a disqualifying transfer of assets. See *Skindzier v. Comm’r of Soc. Servs.*, 784 A.2d 323 (Conn. 2001).
- 5 42 U.S.C. § 1396p(d)(2).
- 6 CMS State Medicaid Manual, Section 3259.6.B, available at https://attorney.elderlawanswers.com/uploads/media/documents/hcfa_transmittal_64_-_sec._3257_-_3259.pdf.
- 7 Citing Letter from Sally K. Richardson, Director of Medicaid Bureau, Health Care Financing Administration, Dep’t of Health and Human Services, to Ellice Fatoullah, Esq., *Elder Law Report*, Vol. V, No. 7, p. 2, Dec. 23, 1993.
- 8 Citing Q & A 83, Summary of Verbal Q & A’s from HCFA Central to the Regions (Nov. 4, 1993).
- 9 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.
- 10 Available at <http://www.sharinglaw.net/elder/Streimer.pdf>.
- 11 See, e.g., *Bush v. Gore*, 531 U.S. 98, 116 (2000), stating that “[t]he election process ... is committed to the executive branch of government through duly designated officials all charged with specific duties.... [The] judgments [of these officials] are entitled to be regarded by the courts as presumptively correct....” See also *Archdiocese of Portland vs. County of Washington*, 458 P.2d 682, 684-685 (Or. 1969), stating that the actions of an administrative agency “will be presumed valid, reasonable, correct, taken in knowledge of material facts, justified by the facts, made upon full hearing or after giving all interested parties a reasonable opportunity to be heard and upon appropriate evidence duly considered and properly applied.” See also *Fairfax Nursing Ctr., Inc. v. Califano*, 590 F.2d 1297, 1301 (4th Cir. 1979), discussing the “judicial presumption of legality of administrative action,” quoting *Springdale Convalescent Center v. Mathews*, 545 F.2d 943, 955 (5th Cir. 1977); *Campaign Clean Water, Inc. v. Train*, 489 F.2d 492, 501 (4th Cir. 1973), vacated and remanded on other grounds, 420 U.S. 136 (1975).
- 12 See, e.g., *Standard Oil Co. v. Department of Energy*, 596 F.2d 1029 (Temp. Emer. Ct. App. 1978).