THE PRACTICAL ESTATE PLANNER

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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, 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. 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 2)

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, Medicaid, and Veterans' Aid and Attendance benefits.[1] In Part 1 of this series, I began the examination of the Living Trust Plus Asset Protection Trust, used by many middle-class Americans seeking asset protection to avoid the devastating costs of nursing homes and other long-term care. I explained how the Living Trust Plus works for Medicaid Asset Protection, including the Medicaid five-year look-back period and the transfer penalty and how they interact. I explained the reasons why clients use the Living Trust Plus Income-Only Trust. I explained how these trusts are allowed under federal Medicaid law—OBRA '93, the Richardson letter, and the Streimer letter.[2] I explained that there can be absolutely no access to corpus by either the settlor or the settlor's spouse and that the trust, although irrevocable, can be terminated under the laws of most states by the agreement of all interested parties.

In this article, Part 2 of the series, I will examine the relevant case law surrounding these types of trusts. All of the trusts in the cited cases were presumably intended to be drafted as "income only trusts," which used to be the most prevalent type of asset protection trust used by elder law attorneys to help clients protect assets in connection with Medicaid, so I will also examine what I believe is meant by "income" in this context. However, please note that over the last decade, most elder law and estate planning attorneys who draft trusts to protect assets in connection with Medicaid use a trust that is more restrictive than the income only trusts described in these cases, in that most Medicaid asset protection trusts are drafted to prohibit the settlor from receiving both income and corpus. As explained in Part 1 of this series, the most commonly used trust 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.

Any retained interest in corpus is fatal

A trust in which the settlor or the settlor's spouse retains any interest whatsoever in the corpus/principal is not an asset protection trust for purposes of Medicaid, nor for purposes of lawsuit protection / general creditor protection (with the exception of domestic asset protection trusts or foreign asset protection trusts, discussed herein, which might work for general creditor protection but are completely worthless in connection with Medicaid).

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 almost every state.

Section 505(a)(2) of the Uniform Trust Code, titled Creditor's Claim Against Settlor, 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." As of May 2021, the Uniform Trust Code has been enacted in 35 jurisdictions and has been introduced in Hawaii and is under study in numerous other states. For a list of States that have adopted the Uniform Trust Code and links to each state's trust code and links to the section 505(a)(2) "creditor's claims against settlor" section, please see the author's website here: https://tinyurl.com/UTC-State-List.

Section 505(a)(2) of the Uniform Trust Code has been adopted in all of the enacting states without any significant change, with the exception of Connecticut and Mississippi, and the relevant section has been introduced but not yet passed in Colorado.

Section 505(a)(2) of the Uniform Trust Code is based on the Restatement of Trusts, Second, section 156, which 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.

The cases cited below further illustrate the point that a trust where the settlor or the settlor's spouse retains any interest whatsoever in the corpus/principal is not an asset protection trust for purposes of Medicaid, nor for purposes of lawsuit protection / general creditor protection, with the exception of offshore and domestic asset protection trusts which will be briefly discussed at the end of this article.[3]

General creditor cases demonstrating ineffective drafting of an asset protection trust

In both United States v. Ritter,[4] and Petty v. Moores Brook Sanitarium,[5] the trust settlor retained the right to have the trust corpus returned to the settlor at the discretion of the trustee. This retained power to return 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.

In Re Robbins v. Webster[6] 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 claims of their creditors.[7]

In the Pennsylvania case of In re Nolan,[8] the settlor retained the power to appoint the remainder and the trustee had the power to re-convey the property to the settlor. The court held that no creditor protection was available.

Medicaid cases demonstrating ineffective drafting of a Medicaid asset protection trust

In Gayan v. Illinois Dept. of Human Services,[9] 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.

In Balanda v. Ohio Dept. of Job and Family Services,[10] 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.

In Wisynski v. Wis. D.O.H. & Family Serv.,[11] the irrevocable trust involved in this case does not appear to have been written as an income only trust, but the opinion is not clear on that issue, as it 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.

Clifford and Ruth Oyloe v. North Dakota Department of Human Services[12] involved a claim by the State Medicaid Agency (Agency) that the assets of the applicant's irrevocable trust were countable for purposes of Medicaid. The Agency challenged the trust on 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." The crucial drafting error was that the trust agreement did not contain a paragraph 1.(d). Accordingly, the court found 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. Importantly, the Agency did not take the position that the other trust assets were countable assets for Medicaid purposes.

Boruch v. Nebraska Dept. Of Health & Human Servs.[13] 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."[14] 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."[15] Clearly, this trust was not properly structured as an income only trust, 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 income only trust such as the Living Trust Plus® Income-Only Trust. 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,"[16]) this interpretation of federal Medicaid law[17] is entirely aberrational and is not supported by the law, and quite possibly it was a clerical error leaving out the word "corpus" in the sentence "[i]f an individual establishes an irrevocable trust with his or her funds and is the beneficiary of or can benefit from the trust [corpus] under any circumstances, the trust corpus is counted in the determination of Medicaid eligibility."[18] In any event, this aberrational finding can arguably be considered dicta in that the trust in question was clearly not properly structured as an income only trust. The court also indicated that the Medicaid applicant in Boruch was the "sole beneficiary" of the trust, 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 income only trust 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 a properly structured income only trust 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 Boruch, it is possible that this might have had an effect on the court's decision.

What is income in the context of an income only trust?

Although neither the settlor nor the settlor's spouse can receive distributions from corpus from an income only trust, they can (or must) receive distributions of trust income. In this writer's opinion, and as defined in the Living Trust Plus® Income-Only Trust, "income" means interest, ordinary dividends,[19] rental income, royalties, and any other taxable income that does not qualify for capital gains treatment. The reason for excluding capital gains from the definition of income is that historically capital gains have been considered to be part of corpus/principal, and trustees were required to distribute only income to the income beneficiaries, retaining the principal/corpus and all capital gains realized by the trust for the ultimate benefit of the trust's remainder beneficiaries.[20]

This view of what constitutes "income" for purposes of the Living Trust Plus® Income-Only Trust is this writer's opinion based upon an abundance of caution developed over many years of dealing with Medicaid officials. It is also based on the desire of most clients to protect as much of their assets as possible using the Living Trust Plus® Income-Only Trust, and defining capital gain as part of principal/corpus, is consistent with this goal. Other commentators do not distinguish between different types of income in the context of an income only trust, and some drafters of income only trusts have historically treated 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.

The IRS definition 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."[21]

The relevant federal Medicaid law, OBRA '93, 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."[22]

Adjustments between principal and income

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. The Trustee must not have the power to adjust between income and principal. Likewise, the Trustee must not have the power to convert the trust to a total return unitrust.

The importance of the above rules is demonstrated by a 2009 Massachusetts case, Doherty v. Director of the Office of Medicaid,[23] in which the Appeals Court of Massachusetts stated that "[we] take this opportunity to stress that we have no doubt that self-settled, irrevocable trusts may, if so structured, so insulate

trust assets that those assets will be deemed unavailable to the settlor."[24] However, the trust reviewed by the court in Doherty, though ostensibly written as an income only trust, was utterly defective in that it allowed distributions of principal via adjustments between income and principal. Although the trust explicitly provided that the trustee may "make no distributions of principal from the Trust, to or on behalf of" the settlor, the trust also gave the trustee the power to "determine all questions as between income and principal and to credit or charge to income or principal or to apportion between them any receipt or gain."[25]

Comparison of the Living Trust Plus with offshore and domestic APTs

The plain meaning of the term "self-settled trust" is a trust established by a settlor for his or her 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.

Source of the confusion

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 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, as explained in detail above, if a settlor has the right to receive any distribution 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.

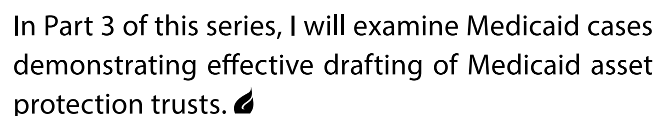
Under current law, this type of self-settled trust is absolutely ineffective for Medicaid asset protection purposes because if either spouse has access to principal, all of the assets in the trust will be deemed "countable" for Medicaid eligibility purposes.

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.

The Living Trust Plus, along with all properly drafted Medicaid asset protection trusts, are certainly "self-settled trusts" 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 settlors the right to receive distributions of principal, but rather only, possibly, distributions of income and the right to use any trust-owned real estate.

In Part 3 of this series, I will examine Medicaid cases demonstrating effective drafting of Medicaid asset protection 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 The Streimer and Richardson letters were written by the then-heads of the Health Care Finance Administration

(HCFA), the predecessor agency to the Centers for Medicare & Medicaid Services (CMS). These letters, taken together, contain the full interpretation of OBRA '93 and, together with OBRA '93, still stand as the federal law governing irrevocable income only trusts.

3 Note that many of the cases cited in this article have been erroneously categorized by some commentators as involving income only trusts, and therefore relied on them to attempt to demonstrate that income only trusts are not effective for asset protection; however, as explained herein, none of the cases cited in the following section involved properly drafted income only trusts, as the trusts involved all contained provisions allowing distribution of principal to the trust settlors.

4 558 F.2d 1165, 1167 (4th Cir. 1977).

5 67 S.E. 355 (Va. 1910)

6 826 F.2d 293 (4th Cir. 1987).

7 Id. at 294.

8 67 A. 52 (Pa. 1907).

9 796 N.E. 2d 657 (Ill. App. Ct. 2003).

10 2008 WL 1822433 (Ohio Ct. App. 2008).

11 Wis. App., Dist. 3, No. 2008AP1280 (Nov. 4, 2008).

12 747 N.W.2d 106 (N.D. 2008).

13 659 N.W.2d 848 (Neb. Ct. App. 2003).

14 Id. at 851 (emphasis added).

15 Id.

16 Id. at 853.

17 42 U.S.C. § 1396p(d)(3)(B).

18 Id. at 854.

19 Perhaps also "qualified dividends," but see n.20 for a further discussion of allowable distributions of income.

20 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).

21 Treas. Reg. § 1.643(b)-1.

22 42 U.S.C. § 1382a(a)(2)(G).

23 908 N.E.2d 390 (Mass. App. 2009).

24 Id. at 393.

25 Id. at 391.