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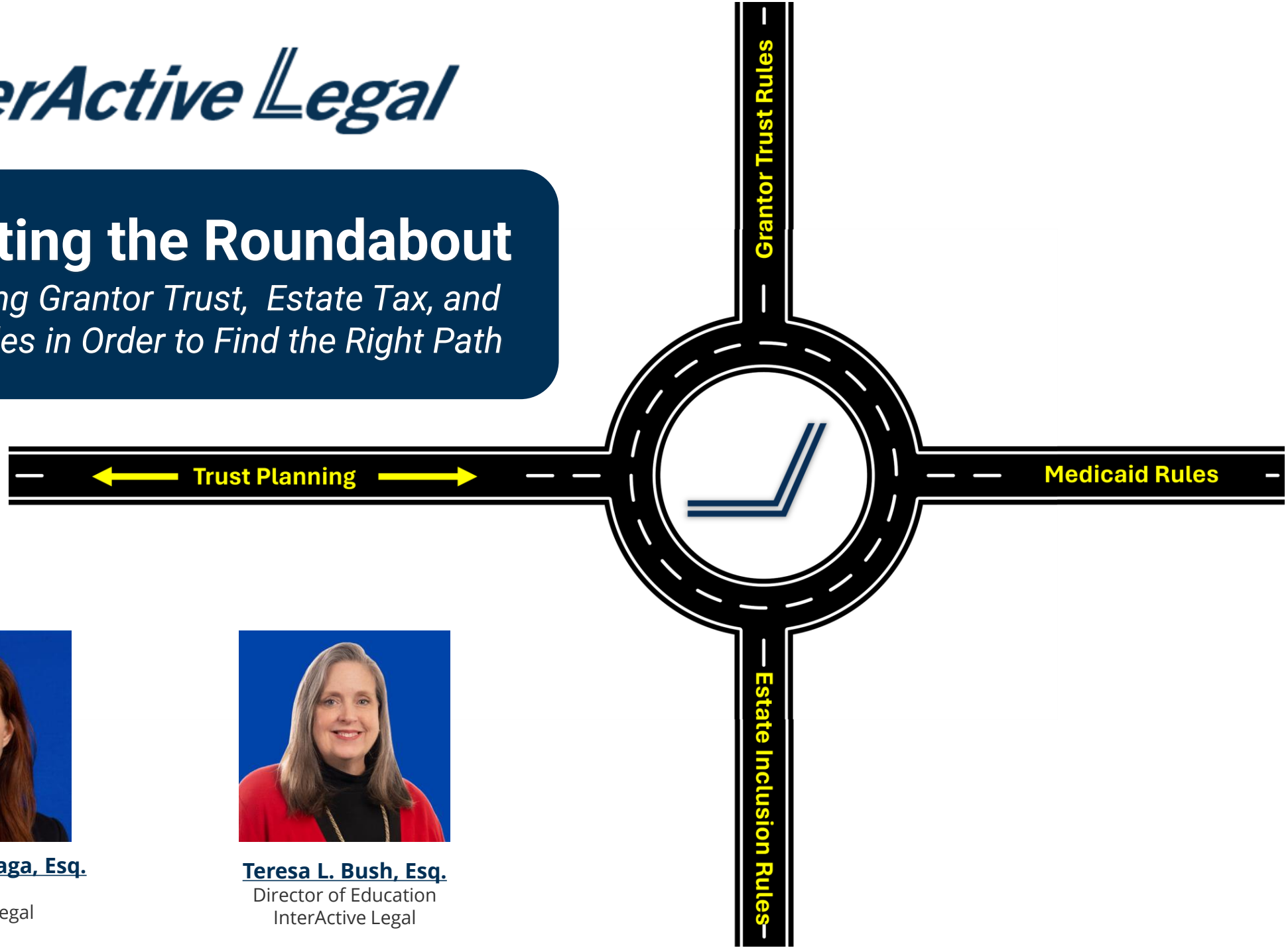
Navigating the Roundabout

Understanding Grantor Trust, Estate Tax, and Medicaid Rules in Order to Find the Right Path



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Objectives

Our objectives today are to consider a few specific trust design issues that are important, but often tedious. These aren't questions that are top of mind for clients – such as how a trust's assets can be used for family members and who will be in charge (as trustee). Instead, these are issues related to current and future income taxation and qualification for different types of government benefits. And as we'll see, making a choice on one issue can impact others, which can in turn impact others.

Overview

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- Grantor and Non-Grantor Trusts
- Estate Inclusion
- Medicaid and VA Planning Trusts
- Hypotheticals
- Summary and Conclusions

Grantor and Non-Grantor Trusts
(and Trust Income Taxation)

Someone Has to Pay the Tax

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- Elder law attorneys and estate planners often prepare trusts for their clients for various purposes. Who pays the tax on trust income?
- There are three potential taxpayers (sometimes only two) with respect to income generated by property owned by a trust:
  1. **The trust itself** might be responsible for the income tax
  2. **A beneficiary** of the trust might be responsible for the income tax
  3. **The grantor of the trust** (if living) might be responsible for the income tax

Who Pays the Tax?

- The Trust: The trust pays the income tax on trust income unless
  - Trust distributions "carry out" income as Distributable Net Income (DNI); OR
  - The grantor or a beneficiary is wholly responsible for the income tax
- The Beneficiary: The beneficiary may bear some or all responsibility for the income tax if:
  - The grantor is not responsible for the income tax, and one of the following is true:
  - The beneficiary is responsible for the tax under Section 678; OR
  - The beneficiary receives DNI from the trust
- The Grantor: A trust creator (the "grantor") is responsible for income tax on trust income if the trust is a "***grantor trust.***"

What's Defective About That?

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- Why do we have the grantor trust rules?
  - Historically, trusts had the same income tax brackets as individuals
  - So, people would create multiple trusts to have multiple "runs up the bracket"
  - The grantor trust rules were implemented to take away this advantage
- However, grantor trusts can provide certain advantages
  - Trusts generally pay more income tax than individuals, so shifting tax to the grantor (an individual) often means lower overall tax (when compared with the trust itself paying the income tax).
  - Trust assets grow income-tax free
  - Grantor and trust are treated as the same income taxpayer, allowing certain benefits and tax-efficient transactions

Introducing the Grantor Trust Rules

- Internal Revenue Code Sections 671-679 (and accompanying regulations)
- Code Secs. 673-679 set forth the rules for triggering grantor trust status
- The most common rules used to intentionally trigger grantor trust status are the rules regarding the "Power to control beneficial enjoyment" under Code Sec. 674 and the "Administrative powers" under Code Sec. 675
- Code Sec. 672 includes important definitions and other rules applicable to the grantor trust triggers

Important Definitions: Section 672

- **Adverse Party:** Any person having a *substantial beneficial interest* in the trust which would be *adversely affected by the exercise or nonexercise* of the power which he or she possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.
- **Nonadverse Party:** Any person who is not an adverse party
- **Related or Subordinate Party:** Nonadverse party who is (1) grantor's spouse, if living with grantor, or (2) any of the following: Grantor's father, mother, issue, sibling; employee of grantor; corporation or employee of a corporation in which stock holdings of grantor and trust are significant in terms of voting control; subordinate employee of a corporation in which the grantor is an executive

Spousal Attribution Rule

- **Code Sec. 672(e)(1):** A grantor is treated as holding any power or interest held by
  - (A) the grantor's spouse at the time the interest or power was created, or
  - (B) any individual who became the grantor's spouse after creation of such power or interest, but only with respect to periods after becoming the grantor's spouse
- Code Sec 672(e)(2) provides that for purposes of Sec. 672(e)(1)(A), individuals who are legally separated under a decree of divorce or separate maintenance are not considered married. *Note*: This does not apply if the spouses are *later* divorced or separated after the trust is created.

Grantor Trust Rules (the simple ones)

- Sec. 673: Reversionary Interests – treats the grantor of a trust as its owner if grantor has a reversionary interest with a value on the date created of more than 5% of the trust fund.
- Sec. 676: Power to revoke – treats grantor as owner of any portion of trust if grantor or a nonadverse party has the power to revoke such portion without the consent of an adverse party.
- Sec. 678 – Person other than grantor treated as substantial owner. Allows another person (typically a beneficiary) to be treated as the owner of a trust so long as the grantor is not the owner under another section.

Grantor Trust Rules (the complex ones)

- Sec. 674: Power to Control Beneficial Enjoyment. A complicated section with many exceptions, and exceptions to the exceptions.
- Sec. 675: Administrative Powers. Various administrative powers that trigger grantor trust status.
- Sec. 677: Income for the benefit of the grantor – treats the grantor as the owner of any portion of a trust whose **income without the approval or consent of an adverse party is, or in the discretion of the grantor or a nonadverse party**, or both, may be **distributed or accumulated for the grantor or the grantor's spouse** (or applied to pay life insurance premiums on life of grantor or spouse).

The Most Complex: Section 674

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- General Rule: Grantor owns any portion of a trust for which the beneficial enjoyment of the principal or income 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**
- Most trusts would fall within this general rule, if not for the exceptions in Section 674
- Important exceptions
  - 674(b)(5)(A): Power to distribute corpus limited by a "reasonably definite standard which is set forth in the trust instrument"
  - 674(b)(7): Power to distribute or apply income to or for an income beneficiary or to accumulate income and add to corpus, only during a period in which such beneficiary is legally disabled or under 21 years of age
  - 674(c): General rule does not apply to a power held by an "independent trustee" meaning not the grantor, and no more than half of the trustees are related or subordinate to the grantor

Power to Add: The Exception to the Exception

- All three of the exceptions listed on the previous slide (which would mean grantor trust status is *not* triggered) have a further exception that applies (meaning grantor trust status *is* triggered)
- The exception to the exception: *Any person* holds a **power to add a beneficiary or class of beneficiaries designated to receive income or principal**, except to provide for after-born or after-adopted children.
- So if we want grantor trust treatment, a "power to add beneficiaries" can trigger Section 674(a), because it negates many of the other more common exceptions set forth in the balance of Section 674.

Testamentary Power of Appointment

- Another exception to the general rule of 674 relates to testamentary powers of appointment
- 674(b)(3) - Testamentary power exception: A power does not trigger grantor trust status if it is exercisable only by Will, BUT
- There is an exception to the exception if: The **grantor holds a power to appoint the income of the trust where the income is accumulated** for such disposition **by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party**, or both, **without the approval or consent of any adverse party**
- What does this mean? If the grantor holds a testamentary power of appointment, and a nonadverse party (such as a trustee) has discretion to accumulate income without consent of an adverse party, the trust likely will be a grantor trust under Section 674

Frequently Used Trigger: 675(4)(C)

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- One of the most frequently-used rules for intentionally triggering grantor trust status is the "Administrative power" of a non-fiduciary to reacquire trust property by substituting property of equivalent value, under Section 675(4)(C) (sometimes called a "swap power" or "power of substitution")
- Why it's popular:
  - May be held by the grantor, generally without causing estate inclusion (See. Rev. Rul. 2008-22)
  - May be held by a third party (some lack of clarity as to whether it must be a nonadverse party)

Grantor Trust Rules Wrap-Up

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- As noted above, some – but not all – of the grantor trust rules are also things that would cause estate inclusion. For example, a retained testamentary power of appointment can trigger both grantor trust status and estate inclusion.
- If a grantor trust power is triggered, but does not cause estate inclusion, then we have what may seem like an odd situation - a gift has been made to a trust that is considered
  - Complete for transfer tax purposes, but
  - Incomplete for income tax purposes
  - (But this isn't a bad thing – it may be exactly what we want)
- Grantor trust status can often be "turned off" – but not always, depending on what rule applies.

Why would I want a grantor trust?

- Estate depletion – the grantor paying the trust's income tax lets the trust assets grow tax-free, and diminishes the grantor's estate.
- Lower income taxes – an individual usually pays less tax on the same amount of income than a trust would, if it were the taxpayer.
- If a grantor trust owns the grantor's personal residence and the residence is sold, the Section 121 capital gains exclusion on the sale of a personal residence is available to the grantor (because the trust is ignored for income tax purposes). However, if a non-grantor trust sells a personal residence, the capital gains exclusion is not available.

Why would I NOT want a grantor trust?

- The client does not have a personal residence and doesn't need to deplete his estate.
- The client does not want to be responsible for income tax.
- The client wants to qualify for VA Aid and Attendance Benefits.

Estate Inclusion

Estate exclusion (and inclusion)

- Irrevocable trusts can be designed to trigger inclusion in the taxable estate, or to be excluded from the taxable estate
- We need to avoid certain powers that would trigger inclusion, if the goal is to save estate tax, where
  - Total assets are potentially over the federal exemption amount (currently $13.61 million)
  - The client is subject to state estate tax (exemptions vary, but may be much lower)
- What if estate tax is not a concern?
  - We may want to trigger estate inclusion for the step-up in basis – if the estate tax will be zero regardless, why not get an income tax benefit?
  - We may be agnostic to estate inclusion, but want to include certain powers in order to trigger grantor trust status
- The rules for estate inclusion and grantor trust status overlap somewhat, but they are NOT the same.

What Causes Inclusion?

- If a client has created an irrevocable trust, estate inclusion of the trust assets can be caused by the grantor holding or retaining certain powers over the trust property
- The "strings" – Sections 2036-2038
- General Powers of Appointment – Section 2041
- Life Insurance – Section 2042

Section 2036

- Section 2036 can be broken down into 3 separate rules: 2036(a)(1); 2036(a)(2); and 2036(b)
- Each of these rules applies if the interest in the gifted property is retained
  - For the transferor's life;
  - For any period not ascertainable without reference to the transferor's death; OR
  - For any period which does not in fact end before the transferor's death

Section 2036: The Retained Interests

- The value of the gifted property is included to the extent that the transferor retained:
  - 2036(a)(1) - "The use, possession, right to income, or other enjoyment of the transferred property"
  - 2036(a)(2) – "The right, either alone or in conjunction with any other person or persons, to designate the person or persons who shall possess or enjoy the transferred property or its income…"
  - 2036(b) – "[T]he right to vote (directly or indirectly) shares of stock of a *controlled corporation*" (see 2036(b) for definition and 318 for attribution rules)
- Note that the value of the entire portion of the property over which the interest is retained is included; not just the value of the interest

Examples: 2036(a)(1) and 2036(a)(2)

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Example 1: Sara creates and makes a gift to an irrevocable trust that provides for all income from the trust property to be paid to Sara, annually, for life. The trustee has discretion to distribute principal among Sara's children, as the trustee determines. The gifted property is includible in Sara's gross estate under 2036(a)(1).

Example 2: Brian creates and makes a gift to an irrevocable trust that provides that the trustees have discretion to pay trust income and principal among Brian's children. Brian names himself as trustee, and serves in that role until his death. The gifted property is includible in Brian's gross estate under 2036(a)(2).

Section 2038: Revocable Transfers

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- Section 2038 provides for inclusion of property gifted by the decedent if at the date of death, the decedent could change the enjoyment of the property through a power to "alter, amend, revoke, or terminate"
  - It does not matter whether the decedent could exercise the power alone or only in conjunction with another person
  - It does not matter "when or from what source the decedent acquired such power"
- Note that 2038 is very similar to 2036(a)(2); however, it does not require the transferor to have "retained" the power to change beneficial enjoyment

Reversionary Interests: Section 2037

- Section 2037 pulls property into the transferor's gross estate if the transferor retained a "reversionary interest" and
  - There is an interest in the enjoyment or possession of the property which is conditioned on surviving the decedent; AND
  - The value of the reversionary interest immediately before the decedent's death exceeds 5% of the value of the gifted property (determined immediately before decedent's death)
- See the examples in the Regulations (§ 20.2037-1)

String Theory

- The idea behind the "string" provisions is that a person cannot remove property from the person's gross estate by making a gift while also retaining the type of interest or power generally associated with ownership of the property. In other words, you can't have your cake and eat it too
- A few notes:
  - If property can be used to satisfy the transferor's "obligation to support" a dependent or to pay the transferor's debts, the property will be included under 2036
  - An "implied agreement" between transferor and transferee can cause inclusion
  - Even if a string is transferred or released, it will still cause inclusion if the release/transfer occurred within 3 years of death
  - Strings – they're not just for trusts! See *Strangi* and its progeny.

Section 2041: General Powers of Appointment

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- Under Section 2041, property is included in a decedent's gross estate if the decedent held a "general power of appointment" (GPOA) over the property at the time of death
- What is a GPOA? A power to appoint trust property exercisable in favor of
  - The decedent
  - The creditors of the decedent
  - The decedent's estate; OR
  - The creditors of the decedent's estate
- Just one is sufficient to create a GPOA.
- A power to appoint with no restrictions on the appointees is also a GPOA.
- To avoid GPOA status, powers of appointment are often exercisable in favor of a limited group (i.e., the client's descendants), or in favor of anyone other than the client, the client's creditors, the client's estate, or the creditors of the client's estate.

Section 2041's Broad Sweep

- Section 2041 applies to any power that is "in substance and effect" a GPOA, regardless of what it is called
- This includes the power of a trust beneficiary to "appropriate or consume the principal of the trust" – e.g., a beneficiary acting as trustee with an unlimited power to distribute to himself.
- A release/lapse or exercise of a GPOA is treated as a taxable transfer for gift tax purposes (unless falling within the "5 and 5" exception)

Exceptions to Section 2041

- Ascertainable Standard (HEMS)
  - Under Section 2041, a power is not treated as a GPOA if it is limited by an "ascertainable standard relating to health, education, support, or maintenance" – often called a "HEMS standard"
  - Sections 2036 and 2038 do not include a similar exception, but it has been applied in a long history of cases
- Adverse Party
  - 2041 exception for powers only exercisable in conjunction with "a person having a substantial interest in the property, subject to the power, which is adverse to the exercise of the power in favor of the decedent"
  - The Regulations define what it means to have a "substantial" adverse interest, but it can be difficult to ensure that a power fits within this exception
  - 2041 also includes an exception for powers exercisable only in conjunction with the person who created the power

Section 2042: Proceeds of Life Insurance

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- Under Section 2042, the proceeds of life insurance on a decedent's life will be included in the gross estate if
  - The proceeds are paid to the executor of the decedent's estate; OR
  - The decedent possessed, at the time of death, "incidents of ownership, exercisable alone or in conjunction with any other person" over the insurance policy
- Accordingly, insurance proceeds can be included in the gross estate even if they are not paid to the estate

Why Would I Want Estate Inclusion?

- Section 1014 Step-Up in Basis:
  - The basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent is **the fair market value of the property at the date of the decedent's death**
  - This basis adjustment can provide significant benefit for property with a lot of built-in gain, if it is later sold by the heirs
- Does grantor trust status result in the 1014 Step-Up?
  - Probably not – See Rev. Rul. 2023-2
  - However, if the trust is included in the estate for estate tax purposes, the step-up would apply, **regardless of grantor trust status**
  - In other words, you don't need a grantor trust to get estate inclusion; you can have either without the other, or both.

Power Comparison

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Power	Grantor Trust?	Estate Inclusion?
Distribute income to grantor	Yes, unless with consent of adverse party (677)	Yes (2036(a)(1))
Distribute income to grantor's spouse	Yes, unless with consent of adverse party (677)	No
Substitute Assets – held by grantor	Yes, if in a nonfiduciary capacity without consent of a fiduciary (675(4)(C))	No (as long as requirements of Rev. Rul. 2008-22 are met)
Substitute Assets – held by other than grantor	Yes, if in a nonfiduciary capacity without consent of a fiduciary (675(4)(C))	No
Testamentary Power of Appointment (held by grantor)	Yes, if income may be accumulated by nonadverse party without consent of adverse party (674(b)(3))	Yes (2038)
Power to add beneficiaries	Yes in many cases (674), but not if consent of adverse party required	Yes, if held by the grantor or a beneficiary

Medicaid and VA Trust Planning

Medicaid and VA Benefits

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- Medicaid and Veterans' Benefits are programs for those with limited assets. Applicants must be medically eligible and financially eligible, and financial eligibility requires having both limited monthly income and limited countable resources (assets).
- Note that VA benefits are a federal program – one set of rules – while Medicaid is a state-run program, and each state will have separate rules.
- To add more complexity, the Medicaid qualification rules can be applied differently in local Medicaid offices.
- The SSA's Program Operation Manual System (POMS) contains many of the rules that are followed to determine what resources are countable for Medicaid, while federal regulations contain rules for VA qualification.

Medicaid and VA Planning Basics

- Clients are often advised to spend down their assets to qualify for government benefits during lifetime – in other words, to give property away so that they no longer own it.
- However, as with estate inclusion, too many strings can mean something the client transferred away is actually pulled back into the client's countable resources.
- If a trust is used for Medicaid or VA planning, the trust will be reviewed by the appropriate office/agency as part of the application process.
- Hence, trusts are often drafted with the audience in mind, to make the issues as clear as possible for the agency worker who will be reviewing the trust (likely a non-lawyer).

Medicaid and VA Planning Trusts

- Clients can use irrevocable trusts to "spend down."
- Transfers during the five years before applying for Medicaid are subject to a penalty, so many clients planning for the future will create a Medicaid planning trust to start the clock on this 5-year lookback period. After five years, the assets in the trust, if properly drafted, should no longer be countable resources for Medicaid purposes.
- VA benefits have a 3-year lookback period, after which the trust assets should not be part of the applicant's "net worth"
- Another major planning difference – for a trust to work for VA planning, neither the grantor nor the grantor's spouse can have any interest in the trust. ***Therefore, a grantor trust does not usually work for VA planning***.

Common Medicaid/VA Trusts

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- Trusts for Medicaid planning are sometimes called "Medicaid Planning Trusts or "Medicaid Asset Protection Trusts." Two general types of Medicaid (or VA) planning trusts are:
- Children's Trusts – an irrevocable trust in which the grantor retains no interest at all, created for the benefit of the grantor's children (often used for VA planning)
- Income Only Trusts – an irrevocable trust in which the grantor retains the right to trust income only.
  - Why? Some clients prefer to keep an income interest
  - Why not? Does not work for VA planning; client may not need (or want to pay tax on) the income; too much income could impact Medicaid qualification

Issues to Consider

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- The primary purpose of this planning is usually to prevent the trust property from being considered a countable resource/asset for Medicaid or VA purposes.
- Transferring property in trust can have income tax consequences, as we have discussed. Who will be the responsible taxpayer with respect to any income generated by trust assets, and does that in any way impact the Medicaid or VA results?
- If the trust property is highly appreciated (having a low tax basis), it may be important to ensure that a step-up in basis is obtained when the grantor dies – which means having the trust property included in the grantor's taxable estate. However, we have to ensure that the powers we include to trigger estate inclusion do not adversely impact the Medicaid or VA result.
- If a residence is transferred to the trust, it may be important to preserve the capital gains exclusion for residential property sold during the grantor's lifetime, which can be done by making the trust a "grantor trust" for income tax purposes. However, we must ensure that grantor trust status does not adversely impact the Medicaid or VA result. (And also we should consider how the grantor can continue living in the residence, if applicable.)

More Issues to Consider

- Which type of benefit is the client planning for - Medicaid or VA? If the latter, the trust should be carefully structured to avoid any income being attributed to the grantor or the grantor's spouse. Hence, an Income Only Trust would not be used for VA planning.
- If the property is jointly owned by spouses, the planner must consider whether to use one joint trust, one trust created by one spouse only, or two trusts (one created by each spouse)
  - This decision may be impacted by issues unique to a particular jurisdiction – such as the cost to transfer property
  - If property is owned as tenancy by the entireties, that could be impacted by a transfer in trust, and could affect creditor protection
  - Income tax issues may factor into this decision as well

Trust Comparison

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Children's Trust:

- Grantor retains no beneficial interest
- Can be a grantor trust OR a non-grantor trust
- Accordingly, can be used for Medicaid OR VA planning
- Can be included in the grantor's estate (even if a non-grantor trust)

Income Only Trust:

- Grantor retains income
- Grantor's retained income = grantor trust per 677 as to ordinary income (more needed for grantor trust status for capital gains)
- Accordingly, not appropriate for VA planning
- Grantor's retained income = estate inclusion per 2036(a)(1)

Trust Design

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- Grantor retains an income interest (Income Only Trust)
  - Grantor trust? Yes, as to ordinary income; principal only if we make it so
  - Estate inclusion? Yes
  - Works to remove trust principal from Medicaid countability? Yes
  - Works for VA planning? NO
- Grantor has no interest in the trust (Children's Trust)
  - Grantor trust? Only if we make it so
  - Estate inclusion? Only if we make it so
  - Works for Medicaid? Yes
  - Works for VA planning? Yes, if not a grantor trust, or if it is a grantor trust but the trust generates no income
- Bottom line: regardless of the type of trust, the objectives are usually to give the grantor enough of an interest in the trust to trigger estate inclusion, and grantor trust treatment if desired, but not too much of an interest such that the trust assets remain countable.
- If we aren't using an Income Only Trust, how do we create grantor trust status and estate inclusion?

Common Trust Powers

- Testamentary Power of Appointment
  - Grantor trust? Yes
  - Estate inclusion? Yes
  - Good idea? It depends; generally not if VA benefits are the objective
- Power of Substitution held by the Grantor
  - Grantor trust? Yes
  - Estate inclusion? No (so we need more)
  - Good idea? It depends.
    - Not for VA planning, because we want to avoid income being attributed to the grantor.
    - In some states, it *might* impact Medicaid qualification. In those states, consider using a different grantor trust power, or giving the power of substitution to someone else.
- Power to add beneficiaries with consent of an adverse party
  - Grantor trust? No
  - Estate inclusion? Yes
  - Good idea? Yes – as a way to trigger estate inclusion but not grantor trust status for VA planning

Too many strings?

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- If a trust is used and the Medicaid application is rejected, what happens next? The applicant could appeal, go to court, or try a different plan. Many cases don't go to court, but there have been some reported decisions.
- One example of what not to do - the *Doherty* case in Massachusetts:
  - The trust was an income only trust, but the trustees had the power to decide that most or all trust assets were "income"
  - The trustees could terminate the trust at any time and distribute trust assets to the "beneficiaries," which arguably included the grantor **
  - Trust document stated that principal could be accumulated for the grantor's later benefit, to ensure her quality of life and comfort, and to respond to changing needs *
  - Grantor had the power to direct principal distributions to her family members (lifetime power of appointment)
  - Grantor had the right to reside in residence owned by the trust

More string theory

- Another case law example more favorable to the Medicaid applicant is the *Heyn* case:
  - Interestingly, this was also an income only trust, and also in Massachusetts
  - Grantor held a power of substitution, which was found to not be problematic
  - Grantor held a lifetime power of appointment in favor of her children – also not problematic
  - The trust owned the grantor's residence, but the right to reside was retained in the deed (not in the trust) – also not problematic
- Given that the income interest is what seems to get these trusts in trouble with the reviewing agency, one prudent idea is to not have the grantor retain an income interest.

Powers/Rights

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Power/Right	Medicaid qualification	VA benefits qualification
Distribute income to grantor	Trust income is countable in determining if income limitation is met; Trust assets are not countable resources (5-year lookback) – but be careful to prohibit access to principal	Trust countable for VA purposes
Substitute Assets – held by grantor	In most states, this power should not cause Trust assets to be countable	Trust likely countable for VA purposes if there is income
Substitute Assets – held by other than grantor	This power should not cause Trust assets to be countable	Trust likely countable for VA purposes if there is income
Testamentary Power of Appointment (held by grantor)	This power should not cause Trust assets to be countable	Trust likely countable for VA purposes if there is income
Power to add beneficiaries exercisable with adverse party consent	This power should not cause Trust assets to be countable	Trust NOT countable for VA purposes (3-year lookback)
Right to reside in residence	Could result in countability in some states (better to exclude)	Could result in countability (better to exclude)

Hypothetical Scenarios

Client #1

Robin is 45 years old, and has approximately $2.5 million in assets, including a house, a brokerage account, checking, savings, and an IRA. She recently went through the process of applying for Medicaid for her mom, who is in assisted living. Robin wants to plan ahead so that she is able to qualify for Medicaid if needed, but also preserve her home and at least a modest inheritance for her children. Robin lives in Arizona.

Client #1 Plan

- Plan: You recommend transferring the home and some liquid assets to an irrevocable trust for the benefit of Robin's children. Robin will sign an occupancy agreement to remain in the home, and because she is currently in good health, it is not anticipated that she will need to qualify for Medicaid or other benefits within the 5-year look back period.
- Grantor Trust Issues: You recommend creating a grantor trust, in order to take advantage of the Section 121 exemption if the home is sold, and to allow the trust to continue to grow free of income tax.
- Estate Inclusion: Given the current exemption amounts, and the fact that Arizona has no state estate tax, Robin is not concerned about estate tax, and would like to have the house included in her estate in order to get the step-up in basis.
- Power of substitution (in a nonadverse party) to trigger grantor trust status; testamentary special power of appointment to trigger estate inclusion

Client #2

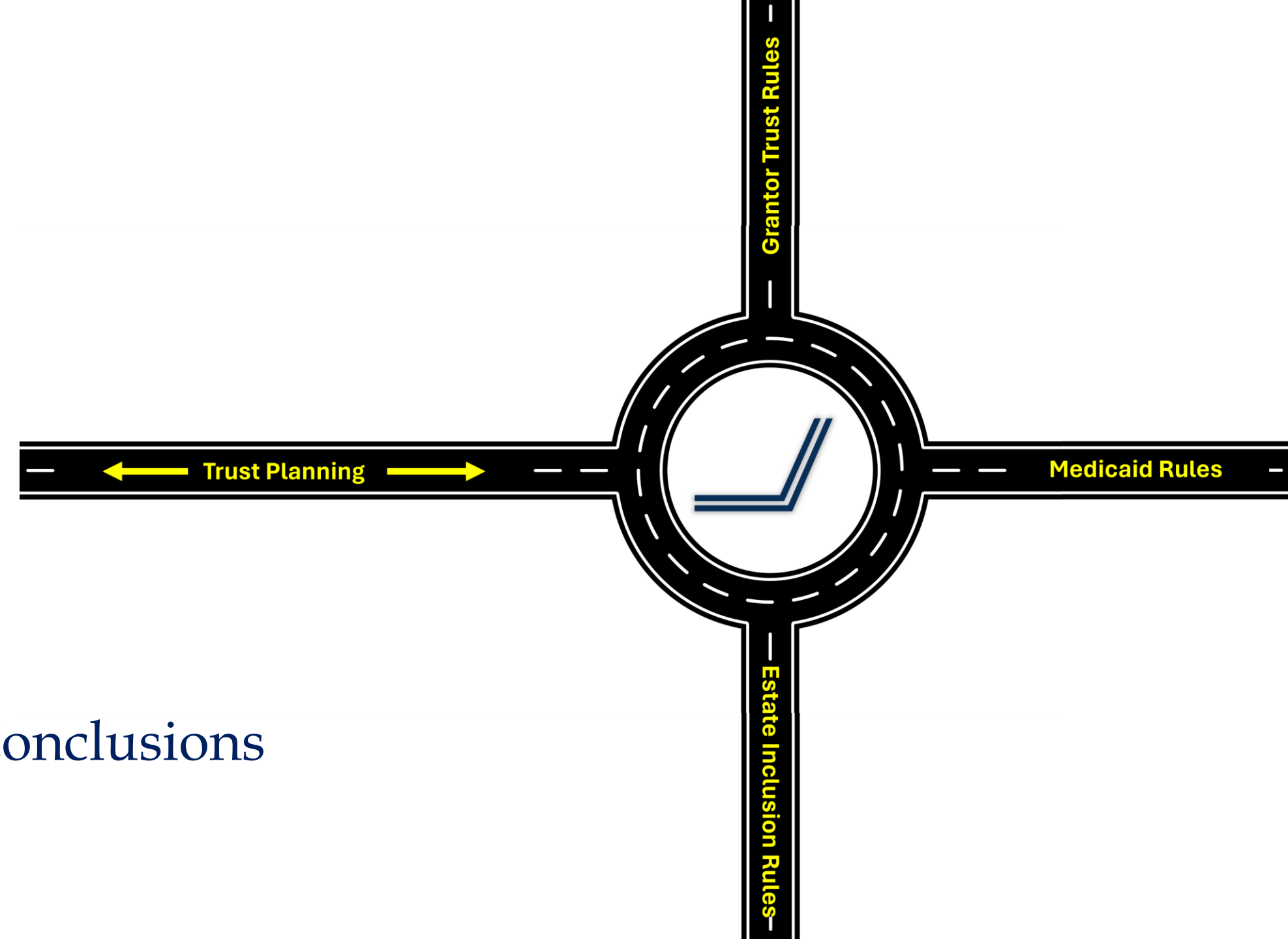
John is 72 and a former Marine. He resides in a residence he owns in Pennsylvania, worth approximately $400,000, along with his adult daughter, Mary, and her husband, Bill. John has an investment account that he and his late wife built over time with their savings, worth approximately $600,000.

John has late-stage Parkinson's disease and his medical team projects he has 7-10 good years left. Mary and Bill are starting to have difficulty caring for him. The family comes to see you about how John can pay for his care with hopes of preserving the assets John and his wife saved over the years.

Client #2 Plan

- Plan: You recommend transferring most of John's liquid assets to an irrevocable trust for the benefit of his daughter, Mary. John's residence is not counted as an asset for VA purposes, so it could stay outside of the trust as long as it's not sold (Mary and Bill plan to live there for some time, including after John passes away). The residence could be moved into a revocable trust to avoid probate, however.
- Grantor Trust Issues: The trust should not be a grantor trust so that no income is attributable to John, and he can qualify for Veterans' Aid and Attendance benefits.
- Estate Inclusion: Given the current exemption amount, having property included in John's estate is not an estate tax concern. To minimize income taxation on the investments after John dies, we should therefore include the trust property in John's estate if possible, to secure the step-up in basis.
- John will retain no interests in the trust at all during his lifetime. He will retain a power to add to the class of beneficiaries at his death, with adverse party consent, which should trigger estate inclusion without triggering grantor trust status.

Summary/Conclusions



Summary and Conclusions

InterActive Legal

- Trusts used for estate planning and Medicaid/VA benefits planning have income tax consequences that planners must consider.
- During the grantor's lifetime, income taxes must be paid, but by whom? Distributions from a complex, non-grantor trust can carry out DNI so income is taxed to the recipient, while undistributed income is taxed to the trust itself. But in a grantor trust, the trust's income is taxed to the trust's grantor and the trust is ignored (which may be a valuable benefit).
- Income tax basis is adjusted under Section 1014 for property included in the gross estate, which may be a valuable benefit that should be preserved, if possible.
- Triggering grantor trust status and estate inclusion must be done carefully if Medicaid or VA benefits qualification is an important non-tax goal.
- Hence, trusts should be designed to get the best/desired tax result while still achieving the overall non-tax objectives, based on all relevant factors.