2010 Holiday Seminar

The Irrevocable Medicaid Trust From Cradle to Grave

Presented by

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Hypothetical Fact Pattern for Mrs. Public

Surviving spouse, Mrs. Public, established an income only irrevocable Medicaid trust in 2002, naming herself and her oldest child as trustees. The trust provides as follows:

(1) For so long as Mrs. Public is alive, income from the trust is payable to Mrs. Public.

(2) Under no circumstances is the Trustee permitted to use principal for Mrs. Public's benefit.

(3) The Trustee, in its discretion, may pay principal to or for the benefit of the class consisting of Mrs. Public's issue.

(4) Mrs. Public reserved, in the trust instrument, the right to tell the Trustee to make a distribution of principal to or for the benefit of one or more of her issue.

(5) Upon Mrs. Public's death, the property in the trust will be paid over to those persons selected from the class consisting of her issue, as designated in a Last Will and Testament referring to this power executed after the execution of the trust.

(6) In the event the power is not exercised, the property shall be sold and the proceeds divided equally among the issue by right of representation.

The property in question was worth $400,000 at the time of the transfer to the trust and the tax assessed value of the property was $300,000. Mrs. Public had acquired the property from her husband six months earlier as the result of his death and the property had been owned jointly. The fair market value of the property at the time of Mr. Public's death was $400,000. Mrs. Public was 75 years old at the time of the transfer into the trust. Simultaneous with the execution of the trust, Mrs. Public conveyed her home to the trust reserving a life estate as well as 1 million dollars in cash and securities. Let's look at the income, gift, estate and MassHealth consequences.

Question 1:

Is the transfer of the property to the trust a completed gift?

Answer 1:

The answer is no. Treasury Regulation 25.2511-2(c) provides that a transfer is an incomplete gift for gift tax purposes if the Donor retains the right to designate the final beneficiaries. See, Paragraph 5, above. Specifically, a gift will be incomplete (but only for gift tax purposes) under Regs. 25.2511-2(c) "if and to the extent that a reserved power giving the donor the power to name new beneficiaries or to change the interest of the beneficiaries as between themselves [make the gift incomplete] unless the power is a fiduciary power limited by a fixed or ascertainable standard."

Planning Note

If the Deed transferred the real estate to a child and the Donor, Mrs. Public, reserved a life estate, there would have been a completed gift, which would need to be reported since the grantor did not reserve the right to designate the final beneficiaries. In addition, if the 1 million in cash and marketable securities had been transferred to a child, a gift tax would have been due since the total gifts would have exceeded the 1 million dollar gift tax exemption.

Question 2:

Does a gift tax return need to be filed?

Answer 2:

The answer probably should be yes, but only to provide disclosure. If the donor retained a provision in the trust rendering the gift incomplete, the Regulations provide that a gift tax return should be disclosed on a return but a failure to file would not render the taxpayer subject to any penalties or gift tax. In most cases, no gift tax return would have been filed. The risk is that the transfer was not incomplete and a gift tax would have been due giving rise to penalties and interest. Specifically, Regulation 25.6019-3(a) provides: "If a Donor contends that his retained power over property renders the gift incomplete and hence not subject to tax as of the calendar quarter or calendar year of the initial transfer, the transaction should be disclosed in the return for the calendar quarter or calendar year of the initial transfer and evidence showing all relevant facts, including the copy of the instrument of transfer, shall be submitted with the return."

Planning Note

If the transfer is occurring in 2010, it may not be enough to simply reserve the right to designate the final beneficiaries. New IRC § 2511(c) provides that, "A transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the (grantor trust rules)."

Question 3:

How do you compute the amount of the gift for gift tax purposes if the transfer of the real estate had been to a child rather than to a trust?

Answer 3:

Assume the 7520 rate applicable for the date of the transfer was 2.4%. Using Table S, single life factors based on Life Table 90CM with interest at 2.4%, the life estate portion is worth .22012 and the remainder interest is worth .77988. Therefore, to compute the value of the gift, you would multiply the <u>fair market value of the property</u> of $400,000 by .77988 ($311,952).

Question 4:

What is the value of the transfer of the real estate for MassHealth purposes?

Answer 4:

Pursuant to MassHealth Eligibility Operations Memo 07-18, the same rate would be applicable by referring you to Table S. The difference, however, would be to use the assessed value rather than fair market value pursuant to MassHealth Regulation 103 CMR 520.007(G)(3)(a). The value of the transfer for MassHealth purposes will be $300,000 multiplied by .77988 ($233,964).

Question 5:

What is Mrs. Public's basis in the property assuming the property was purchased for $40,000 in 1970?

Answer 5:

$400,000 as a result of IRC § 2040(b) and <u>*Gallenstein v. United States*</u>, 92-2 USTC, P60,114 (Ed. KY 1991), aff'd 975 F.2d 286 (6th Cir. 1992). See, also <u>*Patten*</u>, 97-2 USTC, P60,279 (DC CA 1996), and <u>*Anderson*</u>, 96-2 USTC P60,235 (DC MD 1996). This Code Section and these cases stand for the proposition that, as to property acquired by a husband and wife prior to 1977, 100% of the property would be includible in the estate of the first spouse to die. There will be no estate tax because of the unlimited marital deduction, and the surviving spouse would have a full step-up in basis in the property.

<u>Planning Note</u>
If the property had been acquired after 1976, the surviving spouse would have a basis equal to $220,000, determined by adding one-half of the purchase price ($20,000), and one- half of the value on the date of death ($200,000).

Planning Note

It has been suggested that, notwithstanding this well established rule, if the spouse who dies first did not contribute to the purchase price because the deceased spouse was a home maker, for example, then the surviving spouse would receive no step up in basis (and not even one-half). This does not seem to be supported by the Regulations. Regulations 20.2040-1, joint interests, (a)(2) provides: "The entire value of jointly held property is included in a decedent's gross estate unless the executor submits the facts sufficient to show that property was not acquired entirely with consideration furnished by the decedent…" This provision suggests that an election is available to the executor rather than any mandatory rule. There is no case directly on point.

Question 6:

What is Mrs. Public's basis in the property for Massachusetts income tax purposes if different from the federal basis?

Answer 6:

This depends upon when the first spouse died. The governing case is *Treat v. Commissioner*, 52 Mass.App.Ct. 208, 201. The Treat case involved a spouse who died in 1993, several years before Massachusetts completed the repeal of its estate tax system. Dealing with a 1993 death, the Appeals Court relied on General Laws Chapter 65C, §1(d), which is applicable to deaths occurring before January 1, 1997. This section provides:

> "'The federal gross estate', the gross estate as defined under the Code except that, (1) notwithstanding Section 2035 of the Code, the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has, at any time made a transfer, relinquished the power or exercised a released a power of appointment, except in case of a bona fide sale for adequate and full consideration in money or money's worth, by trust or otherwise, during the three year period ending with the date of the decedent's death, provided however, the value of such property or interest therein so transferred or subject to the power so relinquished, exercised, or released, exceeds $10,000 for any person during the calendar year; and (2) notwithstanding Section 2040 of the Code, one-half of the value of any interest in any property shall be included in the gross estate of such interest is held by the decedent and the decedent's spouse as tenants by the entirety or joint tenants with rights of survivorship, but only if the decedent and the spouse of the decedent are the only joint tenants."

This section does not apply to decedents who died on or after January 1, 1997. Under current law, the Massachusetts estate tax, and by implication the definition of gross estate is based upon the federal estate tax credit pursuant to IRC § 2011. As a result, the surviving spouse should acquire a full step-up in basis for Massachusetts income tax purposes, provided the decedent died on or after January 1, 1997. Therefore, in this case, since the decedent died after January 1, 1997 a full step up in basis will apply in Massachusetts as well.

Question 7:

What would Mrs. Public's basis be if she had transferred the real estate to her children and not retained a life interest in the property, but continued to occupy the property as though she owned it and paid all expenses? None of the children reported any income attributable to rent.

Answer 7:

In such a case, the decedent would have acquired a step-up in basis equal to the fair market value of the property on the date of death.

In the Estate of Guynn, 437 F.2d 1148 (4th Cir. 1971), the Circuit Court of Appeals ruled that where the donor and the donee are other than a husband and wife, such as a transfer of a home from a single parent to a child, then the IRS could successfully assert an argument that there was an implied life estate under IRC § 2036. See also, Rev. Rul. 70-155, 179-1CB 189.

Also, in Estate of Maxwell, 98 T.C. 39 (1992), the Tax Court ruled that the value of a decedent's former home should be included in the decedent's estate, even though the decedent "sold" the property to a child for $270,000, required payments of interest only at 9% per year (no principal was required), the decedent's Will forgave the Note at death, and the decedent cancelled $20,000 in a Note each year. The problem was that the decedent did not move out of the house and the Court found that an implied agreement to use and occupy the home existed under IRC § 2036(a).

On the other hand, in the Estate of Powell v. Commissioner, 63 T.C.M. 3192 (1992), the decedent transferred approximately 60% of his ownership interest in his principal residence to his children and their relatives. The decedent died owning 40%. The decedent continued to live in the home until he was forced to move because of his physical condition. The decedent paid all expenses, including real estate taxes, maintenance, and upkeep. The IRS unsuccessfully argued that the decedent retained a life estate under IRC § 2036. The Tax Court disagreed with the IRS's arguments finding that his continued occupation of the residence was consistent with his ownership interest as a tenant in common with his children. See, also Estate of Wineman, 79 T.C.M. 2189 (2000), 24% of the property gifted more than 20 years before death held not includible.

Planning Note

For a decedent dying in 2010, it does not appear as though a step-up in basis would be appropriate in the absence of a legal life estate. Under the so-called 2001 Act, in order for property to be eligible for the modified step-up in basis (up to $1,300,000 in the case of a person other than the spouse and an additional $3,000,000 in the case of property passing to the spouse), the property must have been "acquired" from the decedent. IRC § 1022(d). Property acquired from the decedent is specifically defined in the Internal Revenue Code as follows:

> *(1) property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent. IRC § 1022(e)(1);*
>
> *(2) property transferred by the decedent during his or her lifetime to a qualified revocable trust as defined in IRC § 645(b)(1), IRC § 1022(e)(2)(A);*

(3) property transferred by the decedent during his lifetime in trust with the right reserved to the decedent at all times before his death to make any change to the enjoyment thereof, through the exercise of a power to alter, amend, or terminate the trust. IRC § 1022(e)(2)(B);
(4) any other property acquired from the decedent by reason of a decedent's death, to the extent such property passed without consideration IRC § 1022(e)(3) (e.g., property held as joint tenants with rights of survivorship or as tenants by the entirety); and
(5) the surviving spouse's one-half share of certain community property owned by the decedent and the surviving spouse as community property. IRC 1022(d)(1)(B)(iv).

Planning Note
The basis of property acquired from a decedent may be increased only if the property was owned by the decedent at the time of death. IRC 1022(D)(1)(A). "The decedant shall not be treated as owning any property by reason of holding a power of appointment with respect to such property." IRC 1022(d)(1)(B)(iii). In the case of a life estate it appears that both criteria are met and that the property would be eligible for a step up in basis. Therefore, the situation described in the Estate of Guynn would not operate to obtain a step up in basis if the decedent dies in 2010.

Question 8:

Who is responsible for paying expenses attributable to the property after the property is transferred to the trust subject to a life estate?

Answer 8:

The life tenant is responsible for paying all expenses associated with ownership, with the exception of capital improvements. This means that the life tenant would be paying property taxes and will be entitled to an income tax deduction with respect to such payments. If the property was rental income, then the rental income would simply be reported by the life tenant on Mrs. Public's Form 1040. A remainderman owes no duty of care to the life tenants, absent a duty voluntarily assumed by the remainderman. *Delprete v. Ferrante*, et al, L.W. No. 16-106, Judge King, Suffolk County No. 90-2152B.

Planning Note
It is important to remember that any net rental income generated from the property will be available to the donor of the trust under the terms of the trust, and as such will also be available to the nursing home for MassHealth purposes.

Question 9:

Was the transfer of the property subject to either a five year lookback or a three year lookback?

Answer 9:

With respect to transfers occurring on or after February 8, 2006, a five year lookback applied to all transfers whether or not the property was transferred to an individual or to a trust. 130 CMR 520.019 (B)(2). With respect to transfers occurring prior to that time, a three year lookback applied in the case of a transfer to an individual, but a five year lookback applied to transfers of properties into a trust. 130 CMR 520.019(B)(2), 130 CMR 520.019(B)(3) and 130 CMR 520.023(A). In this case, the lookback will depend upon whether the transfer was made to an individual or to a trust. Since the property was transferred to a trust, a five year lookback is applicable.

Question 10:

How is the transfer penalty (or "period of ineligibility") computed?

Answer 10:

To determine the penalty (or "period of ineligibility"), the value of the gift (in this case $1,233,964) is divided by the average daily cost of private nursing home coverage (also known as the adjustment divisor) on the date of application. 130 CMR 520.019(G)(1). For applications <u>currently</u> filed, the adjustment daily divisor is $274 (or $8,220 per month). In this case, the penalty would be 150.11 months ($1,233,964 ÷8,220).

<u>**Planning Note**</u>
Valuation of the remainder interest is accomplished by 130 CMR 520-019(I)(1). Remember that in Question 4 we computed the value of the remainder interest in the property for MassHealth purposes by multiplying the tax assessed value at the time of transfer, $300,000 by the remainder interest of .77988, to get a total transfer of $233,964. By adding the value of the 1 million in cash and securities transferred into the trust at the same time, a total transfer of $1,233,964 took place on the creation of the trust.

Question 11:

When does the penalty begin to run?

Answer 11:

For transfers occurring prior to February 8, 2006, the penalty begins to run on the date of the transfer. 130 CMR 520.019(G)(3). In this case, notwithstanding the fact that the penalty period of 12 ½ years has not yet run, this transfer would be fully protected under the 5 year lookback rules applicable to transfers into trust.

<u>**Planning Note**</u>
For transfers occurring on or after February 8, 2006, the penalty does not begin to run until the later of when the applicant is institutionalized and otherwise eligible. This basically means that

the penalty doesn't begin to run until after the donor is institutionalized and has less than $2,000. Therefore, YOU MUST WAIT 5 YEARS TO PROTECT ANY TRANSFERS.

Question 12:

Assuming the property was sold on November 1, 2010 for $600,000, what are the income tax and MassHealth consequences?

Answer 12:

- Income Tax Consequences:

In order to sell the property, Mrs. Public, as well as the trustees of the trust, would need to sign the deed. Since the life estate is a property interest, a portion of the proceeds would need to be paid directly to Mrs. Public and a portion would need to be paid directly to the irrevocable trust. The amount to be paid to each party is determined based upon the Table S using the 7520 rate. Basis in the property is similarly allocated.

Cash and the gain are allocated based upon these percentages. That portion of the sale proceeds allocated to the life tenant will be eligible for the capital gain tax exclusion under IRC § 121. As a single person who owned and occupied the residence as her home for two out of the last five years, she would be able to exclude up to $250,000 in capital gain. The balance will be taxable at 15% and 5.3% (Massachusetts). Revenue Ruling 71-122. The portion of the proceeds allocated to the trust may or may not be taxable depending upon whether the trust is a grantor trust. If the property had been deeded to the child instead of the trust, the portion of the proceeds allocated to the child would be taxable as capital gain with no exclusion since the child did not live in and own the home for two of the last five years.

If the trust is a grantor trust, the trust must file Form 1041, identify itself as a grantor trust, and send a tax letter to the grantor informing the grantor that the grantor is responsible for reporting the trust's portion of the gain. In this case, the total gain is $200,000 ($600,000 - $400,000). Assuming the same 7520 rate of 2.4%, the life estate portion is 14.8%, which means $29,600 would be included, but the remaining $170,400 would be reported by the remaindermen. If the remaindermen are the children, it would be fully taxable at capital gain rates. If the remainder portion was owned by a grantor trust, then that gain would be reallocated to the grantor and eligible for the capital gain tax exclusion making the full $200,000 income tax free. Rev. Rul. 66-159 and Rev. Rul. 85-45.

As a result of the sale, a 1099-S will be issued to either Mrs. Public or her irrevocable trust, or both depending upon whether or not Mrs. Public directs the closing agent to issue separate 1099s (one to Mrs. Public and one to Mrs. Public's Irrevocable Trust) in order to reflect the appropriate percentage of the gross proceeds allocated to her (as the holder of the life estate) and to her trust (as the remainderman).

- MassHealth Consequences:

Sale of a life interest is governed by 130 CMR 520-019(I)(2). "If the nursing facility resident's . . . life estate interest or property including the life estate interest is sold or transferred, the value of the life estate interest at the time of the sale (emphasis added) or transfer is calculated in accordance with the Life Estate Tables as determined by the MassHealth agency. The MassHealth agency will attribute the value of the life estate interest at the time of the sale or transfer to the person selling or transferring the life estate."

The portion of the sale proceeds allocated to the life tenant becomes a countable asset, which is once again determined by looking to the applicable 7520 rate and Table S. If the grantor is in a nursing home, to the extent the life tenants share of the proceeds together with other assets exceed $2,000, the applicant would be disqualified from MassHealth benefits unless further action is taken, such as an annuity or an additional gift.

Planning Note

This is probably the biggest disadvantage to retaining a life estate. In this case, assuming a life interest of 14.8%, $88,800 would be allocated to the grantor disqualifying the grantor from receiving benefits. If instead of reserving a life estate the property had been transferred by fee simple interest into the trust, no portion of the sale proceeds would need to be reallocated to the grantor and the entire sale proceeds would be protected from MassHealth and the taxpayer would not have to pay any capital gain because the gain, even though realized by the trust, would be reallocated to the grantor for income tax purposes and it would be eligible for the capital gain tax exclusion under IRC § 121.

Question 13:

Does it make sense to have these clients release/give away their life estate?

Answer 13:

Probably not since the transfer/release of a life estate would create a new penalty period subject to a new look back period. Remembering that the penalty does not begin to run until Mrs. Public is otherwise eligible with assets under $2,000.

Question 14:

Assume instead of selling the property that Mrs. Public dies owning the life estate. What are the estate and income tax ramifications?

Answer 14:

The fair market value of the property is includible in the grantor's estate under IRC § 2036 and, as a result, the property would receive a full step-up in basis. IRC 1014.

Therefore, for deaths occurring prior to and after 2010, there is a full step-up in basis to the fair market value. This means that the trust would acquire a basis in the property equal to $600,000,

and a subsequent sale by the trust would be income tax free to the extent the sale proceeds do not exceed $600,000.

Planning Note
For deaths occurring in 2010, a modified step-up in basis will be applicable pursuant to IRC § 1022. According to these rules, a total aggregate increase in basis of $1,300,000 is permitted to be allocated by the executor to property passing from the decedent. It appears that a life estate is eligible for the modified step in basis.

Question 15:

Is the life estate owned by Mrs. Public subject to estate recovery?

Answer 15:

No, once the life tenant passes away the life estate ends, as does any lien that may have accrued on such property interest, although the legislation has had a tortured history. 130 CMR 515.001(c) followed legislation which subjected life estates to estate recovery for deaths occurring on or after July 1, 2003, but fortunately this legislation has been repealed retroactively to July 1, 2003.

General Laws Chapter 118E, § 31 was amended by striking subsection C (which limited estate recovery to "probate assets") and inserted in place thereof one which read:

> (c) This subsection shall apply to estates of members dying prior to July 1, 2003. For purposes of this section, "estate" shall mean all real and personal property and other assets includible in the decedent's probate estate under the general laws.

The 2003 change also added the following subsection (c ½), but a revision the following year on July 1, 2004 deleted the same.

> "This subsection shall apply to the estates of members dying on or after July 1, 2003. For purposes of this section, "estate" shall mean any interest in real and personal property and other assets in which the individual immediately prior to death on any legal title or interest, to the extent of such interest (emphasis added). This includes interests in real and personal property and other assets that would pass to a survivor, heir, or assignee of the decedent through joint tenancy, tenancy by the entirety, life estate (emphasis added), living trust, right of survivorship, beneficiary designation, or other arrangement."

Question 16:

Is the trust a grantor trust?

Answer 16:

Yes, as to both income and principal. Under IRC § 677(a)(1), the trust is a grantor trust as to income since income, without the approval or consent of any adverse party, is payable to the grantor. Also, under IRC § 677(a), the retained right of a trustee to distribute income and/or principal to the grantor would make the trust a grantor trust unless the distribution must be approved by an adverse party. In this case, however, no principal can be paid to the grantor, and under two private letter rulings, PLR 200531004 and PLR 200523003, the retention of a limited power to appoint by Will is insufficient to make the trust a grantor trust. Therefore, additional provisions are needed to ensure grantor trust status.

Reg. 1.674(b)(3) provides:

> "Under IRC § 674(b), a power in any person to control beneficial enjoyment exercisable only by Will does not cause a grantor to be treated under IRC § 674(a)."

Under IRC § 674(a), the grantor is treated as the owner of any portion of the trust with respect to which the beneficial enjoyment is subject to a power of disposition by the grantor without the approval or consent of any adverse party. (IRC § 674(b)(5) creates limitations to grantor trust status, neither of which apply in this case since the grantor is free without any limitation subject to an ascertainable standard or any obligation to charge a distribution to a future beneficiary's share.) In Mrs. Public's case, the trustee has the power to add one or more 501(c)(3) organizations as beneficiaries of the trust, and as such would make the trust a grantor trust. <u>Madorin v. Commissioner,</u> 84 T.C. 667 (1985).

Question 17:

What are the ramifications of the Doherty Case?

Answer 17:

As a result of <u>*Doherty*</u>, practitioners are reluctant to give or to allow the grantor to retain the right to make discretionary distributions of principal to or for the benefit of their issue, but yet need to be sure the trust remains a grantor trust as to both income <u>and</u> principal. For this reason, the reservation of rights may be limited to appointing principal during life to one or more charitable organizations.

<u>Planning Note</u>
It is not advisable to use an IRC § 675(4)(c) power of administration to reacquire trust corpus by substituting property of an equivalent value to make the trust a grantor trust in a MassHealth/Medicaid setting.