

TAX EXEMPTIONS AND TAX CREDITS UNDER DIFFERENT ESTATE
PLANNING AND ASSET PROTECTION TECHNIQUES

By Attorney Fred J. Forman

Forman, Corcoran & Associates, P.A.

Londonderry and Portsmouth, New Hampshire

York and Portland, Maine

603-434-9500

www.ourlegalwebsite.com

I. BURDEN OF PROOF AND LEGAL STANDARD TO APPLY IN DETERMINING
WETHER THE APPLICANT IS ENTITLED TO AN EXEMPTION OR CREDIT:

- A. The applicant has the burden of showing, by a preponderance of the evidence, that he/she is entitled to a statutory exemption or credit. RSA 72:34 and Tax 204.06.
- B. An applicant is entitled to the exemption or credit if the applicant has **either** the equitable title to the subject property **or** a beneficial interest for life in the subject property. RSA 72:29, IV.

II. OUTRIGHT DEED/GIFT OF THE PROPERTY TO A THIRD PARTY:

- A. The applicant conveys the property to a child or other third party and retains no ownership interest or right to use the property.
- B. This is often done to avoid probate and/or to save estate taxes by gifting assets at a lower value rather than leaving them in their estate to grow and/or to gift assets to reduce the applicant's overall taxable estate for estate tax purposes and/or to protect the asset from a nursing home [the transfer must take place at least 5 years before the applicant can apply for Medicaid; this rule changed in February of 2006 when a transfer to an individual (as opposed to a transfer to an irrevocable trust which carried a 5 year look back period) previously had a 3 year look back period].
- C. This is risky for the applicant because they have lost control of their property.
- D. This also can create capital gains taxes for the transferee (children or other heirs) who will receive a transferred basis in the property (the amount paid by the applicant plus any capital improvements made by the applicant, with a possible partial step up in basis if the property was owned jointly with a spouse and the spouse is deceased) and will forfeit the full free step up in basis.

- E. In this example, the applicant no longer remains on the deed and, therefore, no longer retains equitable title or a beneficial interest. **Therefore, no exemption or credit should be granted or extended.**

III. DEED OF THE PROPERTY RESERVING A LIFE ESTATE:

- A. The applicant conveys the property to a child or other third party and may retain the right to live at or use the property for life. The property interests are split between the life tenant (the applicant making the transfer) and the remaindermen (the children or other heirs who will receive the property without restriction at the death of the life tenant).
- B. The applicant avoids probate and preserves the free step up in basis for his/her heirs. Only a portion of the property is protected from the costs of a nursing home after 5 years (this changed in February, 2006 changing the old rule which had a 3 year look back period). The portion protected is based upon the age of the applicant when they make the transfer. The older they are, the lower the retained life estate subject to Medicaid and the greater the remainder interest exempt from Medicaid after 5 years. Assessors are likely to see less of these transfers for Medicaid planning because of the new rule which only protects a portion of the property from Medicaid, but may still see this technique used as a less expensive probate avoidance tool than an irrevocable trust for those who want to maintain control and pass on a free step up in basis which is not possible under an outright transfer.
- C. In this type of transaction, the applicant is retaining a beneficial interest for life through the right to live at the property for life. **Therefore, the exemption or credit should be granted or extended.**

IV. REVOCABLE TRUST

- A. The applicant conveys the property to a trust of which the applicant is the creator of the trust (known as the Grantor or Settlor) and may also be a manager of the trust (known as the Trustee) alone or with others and is also the recipient (known as the beneficiary) of the trust assets while the applicant is alive and the applicant also reserves the right to amend or terminate the trust at the applicant's discretion. A **nominee trust** or a **realty trust** might also be used for this purpose and could also qualify for an exemption or credit if the applicant is a beneficiary of the trust or upon revocation of the trust (or the end of its stated term of years) the applicant would be re-vested with title to the property.
- B. The applicant avoids probate and preserves the free step up in basis for his/her heirs and the transfer has no tax affect since a revocable trust is a Grantor Trust under IRC Section 671 (therefore, the trust does not have to file any tax returns and uses the social security number of the applicant). The trust can

also provide liability protection for the heirs in the form of spendthrift provisions protecting inheritances from lawsuits or divorces and/or management for young or disabled beneficiaries. However, none of the property is protected from the costs of a nursing home.

- C. Because the trust is revocable, the applicant is reserving a possible reversionary interest in the property (the right to take it back out of the trust) which creates an equitable interest in the property. Also, because the applicant is a beneficiary of the trust, the applicant has equitable and beneficial title to the property. In a trust, the Trustee holds legal title to any trust assets and the beneficiary holds equitable title to any trust assets.

D. Therefore, the exemption or credit should be granted or extended.

V. IRREVOCABLE TRUST

- A. The applicant conveys the property to a trust which cannot be revoked and to a larger or smaller extent (depending on the trust) cannot be changed and of which the applicant may or may not be a Trustee or a co-Trustee and of which the applicant's children or other heirs are the beneficiary (with a provision to allow those beneficiaries access to the principal of the trust either at the applicant's death or during the life of the applicant). Since, under property law, a Trustee of a trust holds legal title to the assets in the trust while the beneficiary holds equitable title, **it should not matter whether the applicant is a Trustee or a co-Trustee in determining whether the exemption or credit should be granted.**
- B. The applicant often sets up such a trust to remove appreciating and potentially taxable assets from the applicant's taxable estate for estate tax purposes and/or to shelter the assets in the trust from long term care costs by claiming that the asset no longer belongs to the applicant (subject to the 5 year look back period). The applicant cannot give any discretion to the Trustee to convey principal back to the applicant or the state will assume that the trustee will exercise such discretion in favor of the applicant if the applicant enters a nursing home and the entire principal can be reached. Likewise, if the applicant gives any discretion to the Trustee to convey income back to the applicant the state will assume that the trustee will exercise such discretion in favor of the applicant if the applicant enters a nursing home and the entire income can be reached. However, many such trusts do give the applicant the right to all income so that the applicant can retain the earnings or interest on their bank accounts and other investments.

- C. The irrevocable trust can be preferable to giving assets away since the applicant retains the income in many cases and the asset is still available should the trustee (often a child or trusted family member or friend of the applicant) need to get money back to the applicant; although this must be done indirectly by allowing the trustee to convey trust assets to the beneficiaries (children or other heirs) who then pay for the needs of the applicant. This also keeps the assets in a pot which can be held if the applicant enters a nursing home before the 5 year look back period has expired, rather than forcing the applicant to have to chase children or other heirs for a return of the assets (assets which they may have spent or lost by the heirs and potentially resulting in some heirs who have their share paying for those who no longer have their share).
- D. Many irrevocable trusts contained provisions which sought to give the applicant some control over the trust. These usually included the right of the applicant/Grantor to reside in the house owned by the trust (**such a right is like a life estate within the trust and does vest equitable rights in the applicant/Grantee and does result in the applicant retaining the exemption or credit**) and/or a power of appointment by which the applicant could change the beneficiaries who would receive the trust at the death of the applicant and/or a power allowing the applicant to remove and replace the trustee. Since the applicant could change trustees and control the beneficiaries, the theory was that the trustees would also do exactly what the applicant told them. The applicant got the best of both worlds; they could claim the assets in the trust were no longer theirs when applying for Medicaid, but they still controlled the assets in the trust. These provisions may be relevant in determining the applicability of credits and exemptions (as will be discussed below). However, future irrevocable trusts will not be as likely to have such provisions because The Deficit Reduction Act put limits on such provisions effective February, 2006. In order to qualify as Medicaid protected, trusts can no longer have such provisions. Also, any attempt to retain a life estate within the trust (**while still allowing the applicant/Grantor to retain exemptions and credits**) will be treated as a life estate and subject a portion of the property to recovery by Medicaid (see life estate discussion in III above).
- E. A risk to the irrevocable trust can be that if the trust is not set up correctly it can become its own taxpayer. This means that the trust will have to file income tax returns each year and the sale of any assets will be paid at the high income tax rate of a trust (as of 2007, earnings over \$10,450.00 in any one year are taxed at 35%). Also, a sale of a residence can lose the \$250,000.00 per person capital gains exemption. There can also be a loss of the \$100,000.00 per person homestead exemption. One way to avoid this problem (and to have the trust taxed to the applicant just like with a revocable trust) is to set up the trust to be taxed as a Grantor trust under IRC Section 671 by having the applicant or the trustee retain certain rights

which cause the trust to be “defective” as its own taxpayer. However, some of these rights will cause the trust to lose its nursing home protection (such as the right of the applicant to revoke the trust or borrow money from the trust). Two such rights which have been used in recent trusts in an effort to not affect Medicaid eligibility but to preserve Grantor trust status have been the use of a right of the Grantor/applicant to substitute assets of equal value and reacquire trust assets and/or the right of the trustee to purchase life insurance on the life of the Grantor/applicant. Since the first of these two rights involve actions of the Grantor, it is generally considered safer from a nursing home planning context to only include the life insurance option since that requires an act of the trustee and cannot re-vest trust assets in the name of the grantor. Although, as will be discussed below, the reacquiring of assets has been looked at in the applicant’s favor by the BTLA.

- F. The biggest challenge the Assessor will face is determining the applicability of a credit or exemption when faced with a property held by an irrevocable trust, in part because the Assessor will need to look at the trust and determine what factors result in the applicant holding equitable or beneficial rights and in part because there is not a lot of law on this topic and the little law there is results from erroneous assumptions of and/or incomplete knowledge on the part of the BTLA.
- G. One such case, decided by three of the non-lawyer members of the BTLA (after looking at what they described as a poorly drafted and contradictory trust of which the applicant was the Grantor and the applicant and her daughter were the co-Trustees and the applicant’s children were the beneficiaries) illustrates this point: Anita R. Stolte Irrevocable Trust v. City of Concord, BTLA Docket No.: 22569-07EX, Decision dated October 12, 2007; rehearing denied. While such decisions have no precedential value as it relates to the Superior or Supreme Court, the BTLA will look at such prior decisions in deciding future cases. This case illustrates that the BTLA will look at multiple factors when reviewing an irrevocable trust, all geared toward deciding whether the Grantor/applicant retained an equitable or beneficial right to the assets within the trust. The BTLA, in what appears to be an attempt to try to reach for a result, found that the taxpayer had a beneficial interest for life in the property in the irrevocable trust and was entitled to continue to take her deceased husband’s veteran’s exemption which had been continuously taken since the purchase of the property in 1965. The BTLA focused on several things in the irrevocable trust.
- H. First, the BTLA focused on the fact that even though the grantor retained no life estate in the property in the trust **and** even though 3.1 of the trust stated that “the [g]rantor does not retain any interest in the principal of [the trust]...” **and** further stated that “[n]o principal may be distributed to

the grantor”, because no principal could be distributed to the children as beneficiaries until after the death of the grantor (and this was contained in a section entitled “Reserved Powers And Rights Of Grantor”), this somehow meant that “primarily” the trust “exist[ed] for the benefit of the Taxpayer during her remaining life.” This ignores the fact that no principal could be distributed to the Grantor either and the Grantor specifically gave up any beneficial interest in the trust assets. This also ignores the fact that the Grantor has no right to live at the property, would have no power to sell the property, would have power to reacquire the proceeds from the sale of the property and could be dispossessed of the use of the property by the Trustee. This also ignores the fact that the Grantor was using this trust to show that she no longer had the asset for purposes of Medicaid. Therefore, she would be saying that the assets in the trust are not hers (beneficially or otherwise) when asking for state aid (Medicaid) but is saying the asset is beneficially hers when asking for a tax credit. In many trusts, this will not be an issue because many irrevocable trusts give the Trustees the option to make distributions of principal to the heirs as beneficiary during the Grantor’s lifetime; otherwise there is no option to get money out of the trust if the Grantor needs money during any look back period or thereafter.

- I. Second, the BTLA focused on Clause 4 of the trust which provides that “[d]uring the lifetime of the Grantor, the Trustee shall distribute the net income of this trust to the Grantor, no less often than quarterly...”. The BTLA used this clause to conclude that this created a beneficial interest in the property within the trust because the taxpayer could retain “any rental income or like-kind residency value...”. Again, this ignores the fact that in order to qualify for the veteran’s credit, this would have to be the Grantor’s residence and would not be rented out and would not be generating income (so the Grantor would receive no benefit from the trust). This also ignores the fact that so long as the property is not rented out the Grantor has no control over it or even a right to live there; and if the trust were to rent out the property and give the income to the taxpayer, no veteran’s credit would apply since this would no longer be her residence. This also ignores the fact that the income provision was placed in the trust so that the taxpayer could retain income from income producing assets such as bank accounts and securities and not any retained value from the residence. This also ignores the fact that the income provision was placed in the trust as an income tax provision to shift trust income to the lower tax rate of the Taxpayer. Again, how can the taxpayer claim she no longer holds any interest in the property when asking for government money (Medicaid) but claim she has a beneficial interest when seeking to lower her taxes in the form of a credit. This is double dipping and inconsistent. You can bet that when appearing before

Medicaid, the taxpayer will argue no retained beneficial interest in the trust. The taxpayer should not be allowed to take two different positions with two different governments or agencies.

- J. Third, the BTLA focused on the fact that Clause 7 of the trust allows the Grantor to waive any rights of the Grantor for the benefit of the Grantor. Again, if those rights do not amount to a beneficial right under the trust, so what if they can be waived. Also, again, the BTLA doesn't understand that this provision was placed in there in response to The Deficit Reduction Act, effective February, 2006. Because the Act attacks certain rights which Grantors tried to retain in irrevocable trusts as no longer being Medicaid protected, the attorneys who draft these trusts now like to have a provision such as this so that if it turns out that a right given to a Grantor would disqualify the trust, the Grantor can waive that right (it is critical to draft it this way since the operative terms of an irrevocable trust cannot be changed once executed). Also, who cares if the taxpayer can waive a right which did not give rise to equitable or beneficial interests for life in the first place.
- K. Finally, while not specifically addressed by the BTLA, the trust at issue at 7.7 provided that "[t]he Grantor shall have the power to reacquire any item of the trust principal by substituting other property of an equivalent value." This may be an area ripe for taxpayer argument in the future. The taxpayer can argue that this section gives them the right to reacquire the property and that, therefore, they maintained some kind of beneficial right to the property. Again, this type of section is only in the trust to qualify the trust as a "Grantor Trust" for income tax purposes and to preserve free step up in basis (see discussion in V.E. above). Also, this presumes the taxpayer has the assets to reacquire the property since equivalent value must be paid. The taxpayer bears the burden of showing that they have sufficient assets outside the trust to even reacquire the property, a burden they generally cannot meet if they have placed most of their assets into the trust.
- L. Conclusion: Despite the BTLA case study cited above, a properly drafted irrevocable trust that completely exempts property from consideration as a countable asset for Medicaid after the Deficit Reduction Act, effective February, 2006, should leave no equitable title or beneficial interest for life in the hands of the Grantor and the exemption or credit should not apply. That having been said, not all such irrevocable trusts are artfully drafted and each trust needs to be examined on a case by case basis.