A Tax Map to Your MAPT

By Christina Lamm

Introduction

A Medicaid Asset Protection Trust (MAPT) is an irrevocable trust that allows an individual to protect his or her assets from Medicaid. Once the MAPT is established, assets are transferred into the trust which contains specific language to allow the trust to be considered an exempt asset for Medicaid purposes once the applicable lookback period has expired. Simply put, the MAPT assets will not count as a resource when making an application for Medicaid if the transfer of assets into the MAPT is beyond the applicable lookback period.

Drafting the MAPT is not so simple. The attorney draftsperson has to ask himself or herself many questions, such as: have the assets being placed in the trust appreciated in value (necessitating a step-up in basis and estate inclusion)? Are the assets being placed in trust expected to appreciate in value, making removal from the estate desirable (necessitating that the transfer be a completed gift)? Will the client need access to the income in the trust? Will the client potentially need to gain access to some of the principal in the trust? Should the trust be a grantor trust so that income is taxable at the grantor's tax rate? These are just some of the questions that the drafter must take into consideration when preparing a MAPT. The attorney draftsperson of the trust needs to make sure that he or she understands the needs of the client to evaluate which tax friendly terms to include in the trust. While the client's only goal may be Medicaid eligibility, tax savings opportunities should also be examined.

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This article will focus on the effects that different provisions in a MAPT have on gift tax, estate tax and income tax as well as the potential benefits and drawbacks to the provisions based on the individual client's needs. Some provisions will overlap and cause estate inclusion and grantor trust

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status, so it is very important for the estate planning attorney to be familiar with the Internal Revenue Code (IRC) sections that govern in this realm.

Income Tax Implications

The trustee of a MAPT is responsible for reporting all income generated by the MAPT, and seeing to it that any income tax due is paid. The question is who pays the tax: the trust, the grantor, or even the beneficiary? That answer can differ depending on the client's goals and financial picture. If the trust is set up as a grantor trust,[1] the grantor will be the one paying the tax on the trust income regardless of whether any income is actually distributed to the grantor.[2]

One advantage to having a MAPT be a grantor trust is that grantors are usually taxed at a lower tax rate than trusts as the income tax brackets for trusts are compressed. In 2021, where the taxable income of a trust exceeds $13,050 it is taxed at the maximum rate of 37%. In contrast, an individual's taxable income is not taxed at the maximum rate until it exceeds $523,600. Thus, substantial income tax savings may be available if the MAPT includes grantor trust provisions allowing the grantor to be taxed on the income generated as opposed to the trust bearing the burden of paying the income tax.

Certain sections of the Internal Revenue Code must be incorporated into the MAPT for it to be deemed a grantor trust for income tax purposes and cause the income to be taxed to the grantor (or a third party in certain instances).[3] IRC §§ 671-679 are commonly known as the grantor trust rules. A deeper look at a few of these code sections and whether to include them in a MAPT follow.

Under IRC § 673, entitled "Reversionary Interests," the grantor is treated as the owner of any portion of the trust in which he or she has a reversionary interest and the interest exceeds 5% of the value of such portion.[4] Giving the grantor a reversionary interest is not advised when the goal is to protect the assets from Medicaid or gain Medicaid eligibility. If the grantor can or will reacquire at least a portion of the assets this may make the trust assets available for Medicaid eligibility purposes. A provision granting a revisionary interest should not be included in the MAPT to obtain grantor trust status.

IRC § 674 deals with the power of the grantor and/or a non-adverse party to control beneficial enjoyment of the transferred property.[5] This section applies whether the power is over principal or income or both. There is a list of exceptions to the rule that the drafter of the trust should familiarize himself or herself with if trying to achieve (or avoid) grantor trust status.[6] If the attorney draftsperson wants to gain grantor trust status through this code section, a limited lifetime power of appointment retained by the grantor to change the income beneficiaries or the remainder beneficiaries of the trust can be included in the MAPT. If the trust is being created to protect the assets from Medicaid (or other governmental benefit programs), the attorney draftsperson needs to make sure that the power is a limited power of appointment. A general power of appointment allows for the grantor to exercise the power of appointment in favor of the grantor, the grantor's estate, the creditors of the grantor or the creditors of the grantor's estate, and would cause the trust to be a countable resource for Medicaid purposes. A limited power of appointment may be flexibly drafted, but must exclude as a potential beneficiary the grantor, the grantor's creditors, the grantor's estate or the creditors of the grantor's estate.

IRC § 675 deals with administrative powers reserved by the grantor or a non-adverse party.[7] For the purposes of a MAPT, the most useful provision to add to the trust is the power of substitution.[8] This power allows the grantor to transfer trust property to himself or herself in exchange for property of equivalent value. While this power can be largely illusory and most often is used exclusively to gain grantor trust status, it has an additional advantage. When the transfer of assets to the trust is a completed gift (discussed below) and the transferred property is not included in the grantor's estate, the ability to swap out appreciated assets for unappreciated assets—thus preserving a step-up in basis that would otherwise not be available—is a valuable bonus.[9]

One last grantor trust provision often used to trigger grantor trust status in a MAPT is IRC § 677.[10] This code section states in pertinent part that the trust will be a grantor trust if the income is or may be payable to the grantor (or the grantor's spouse). It is important thing to note that when income payable to the grantor under IRC § 677 is the provision used to deem the trust a grantor trust, then the drafter needs to take into account that any income generated by the trust will be countable for Medicaid purposes. This can be problematic as the income generated by the trust will be included in the calculation of the Medicaid recipient's total income whether or not income is actually distributed. It may also be included in the calculation if the grantor only has a discretionary right to income generated by the trust.[11]

One way to avoid this potential pitfall is to have the income payable to a beneficiary of the trust (other than the grantor) and use a different provision to make the trust a grantor trust (presuming the grantor does not need the income). For instance, income could be payable for life to the grantor's children. As long as the trust is a grantor trust (based on another grantor trust provision), the income will still be taxed at the individual's rate, but will not be countable for Medicaid purposes.

Gift Tax Implications

If the transfer of assets to the MAPT is deemed a completed gift,[12] a gift tax return must be filed. The filing of a gift tax return will be an added expense, but no gift tax is due [13] as long as the total value of taxable gifts during

the grantor's lifetime are under the estate tax exclusion amount (which for 2021 is $11,700,000). Since the combined estate and gift tax exclusion amount is currently so high, imposition of gift tax is not a major concern; however, depending on the value of the grantor's assets, it can play a role. If the grantor's assets are such that there may potentially be a taxable estate upon death, transferring assets to a MAPT, making sure the transfer is a completed gift, will have the effect of removing the growth on those assets from the grantor's taxable estate as of the date of the completed gift.

Additionally, the political winds are uncertain and tax laws, including the current high estate tax exclusion amount, can change at any time. If the trust is being drafted for a high-net-worth client, it may be prudent to have the transfer deemed a competed gift even if a tax is assessed (but not due until death if under the exclusion amount). The IRS has clarified that even if the gift tax exclusion amount gets lowered to pre-2018 levels, the higher exclusion amount in effect at the time of the gift will be applied.[14]

In order to make sure that the transfer into the MAPT is a completed gift, the grantor cannot retain any of the so called "strings of ownership."[15] These provisions will be discussed in the following section as they also pertain to estate tax implications.

Estate Tax Implications

If the transfer of assets to a MAPT is not a completed gift for tax purposes, then the value of the assets will be included in the grantor's taxable estate upon his or her death.[16] Here, the attorney draftsperson needs to be aware of the client's goals in order to determine if this is right for the client. It is important to remember that while the federal estate tax exclusion amount is $11,700,000 for 2021, it is due to sunset on December 31, 2025 and revert to the pre-2018 level of $5 million (indexed for inflation). It is critical that the attorney consider whether the client will have a taxable New York estate ($5,930,000 estate tax exclusion amount in 2021). It is also important to note that if New York State estate tax may be an issue, gifts made within three years of death will be clawed back for purposes of calculating the New York State estate tax.

With all of that said, many clients do not have to worry about the implementation of an estate tax.[17] Particularly, if your goal is to protect assets from Medicaid it is likely your client will not have assets that exceed the estate tax exclusion amounts. If this is the case, the drafter should think about including provisions in the MAPT so that the assets are included in the grantor's estate upon his or her death.

One major benefit of estate inclusion is to allow for a step-up in basis upon the death of the grantor.[18] For many clients, their most valuable asset is their real property, which can have a large looming capital gain. If the real property is deemed transferred at death it will receive the IRC § 1014 step-up (or step-down) in basis. For example, if the client purchased a home for $90,000 which is valued at $900,000 at the time of death, the cost basis of the property receives a step-up to $900,000, thus eliminating or reducing any capital gains tax due upon the sale of the property post-death.[19] This is also true for the house transferred into a MAPT where the grantor retains some incidents of ownership. In such a case, upon the death of the grantor, the beneficiary will receive the property with a cost basis of $900,000, just as if the grantor continued to own the property in his or her name until death, thus eliminating the capital gain that would be imposed if the property was transferred into the MAPT as a completed gift.

The question is how does the attorney draftsperson make sure that the transfer of assets into a MAPT is an incomplete gift for estate tax purposes? This is where the string provisions of IRC §§ 2036–2038 come in. These provisions are referred to as "string" provisions because they are thought of as strings that the grantor retained over the trust assets. These strings pull the assets transferred into the MAPT back into the grantor's estate. For purposes of drafting a MAPT, §§ 2036 and 2038 are the most relevant.

Section 2036 is titled "Transfers with Retained Life Estate." In pertinent part, it states that a person's gross estate will include any property transferred for less than adequate consideration in which the person retains for the person's lifetime the "(1) the possession or enjoyment of, or the right to the income from, the property or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."[20] In the irrevocable trust context this boils down to if the grantor retains a lifetime right to live in the property owned by the trust; has the lifetime right to receive income from property owned by the trust; acts as trustee with the discretionary right to distribute income or principal not based on an ascertainable standard; or even the right to change beneficiaries of income and/or principal interests, in such cases the value of the transferred assets will be included in the grantor's gross taxable estate upon his or her death and the assets will receive a step-up in basis.

If a drafter wants to make sure that the transfer of assets to a MAPT is treated as an incomplete gift, the drafter can include a limited lifetime or testamentary power of appointment over the assets. As discussed earlier, this power would allow for the grantor to change the beneficiaries of the trust. It is important to keep in mind the Medicaid implications, previously discussed, detailing why the power must be limited.

If the grantor's residence is being transferred into the MAPT, the lifetime right to reside in the property can be included in the trust. Including a lifetime right to possession of real property that is the grantor's personal residence has other added benefits. The grantor can retain any real estate tax credits he or she is receiving and also still remain

eligible for the IRC § 121 exclusion of $250,000 ($500,000 for married couples) of capital gain if the residence is sold before the death of the grantor.[21]

The grantor can also retain a lifetime income interest over the property transferred into the MAPT. As discussed earlier, reserving an income interest is one of the provisions that would also trigger grantor trust status causing the income to be taxed to the grantor, so if the goal is to avoid grantor trust status this needs to be kept in mind. There could also be negative Medicaid consequences as previously mentioned.

Section 2038 is entitled "Revocable Transfers," but that is a misnomer. The retention by the grantor of the power to alter, amend, revoke or terminate the trust will all cause estate inclusion of the transferred assets.[22] Many of the powers that would cause estate inclusion under IRC § 2036 would also cause estate inclusion under IRC § 2038, but a separate discussion of § 2038 is still merited.

It goes without saying that a trust revocable by the grantor would fall under § 2038 (and many other provisions previously discussed) and be included in the gross estate of the grantor, but a MAPT cannot be revocable in order to serve its purpose. The attorney draftsperson of a MAPT needs to understand which powers to alter or amend under § 2038 will cause estate inclusion while allowing the trust assets protection for Medicaid eligibility purposes.

A limited testamentary power of appointment would cause estate inclusion under § 2038. This provision would give the grantor the right to change the beneficiaries by exercising the power in his or her will. Again, this must be a limited power and the grantor must not be able to exercise this power in favor of the grantor, the grantor's estate, the grantor's creditors or the creditors of the grantor's estate.

As with IRC § 2036, the unrestricted power to remove and replace a trustee with the grantor or a person who is related or subordinate to the grantor, as defined under IRC § 672(c), will cause estate inclusion. The unrestricted power by the grantor to remove a trustee, without the restriction to appoint a trustee who is not related or subordinate, is not recommended for a MAPT as it will cause the grantor to be seen as having access to the trust assets because he or she can remove the trustee and appoint himself or herself or someone related or subordinate as trustee. This is viewed as having the ability to direct the assets back to oneself and the value of the trust assets will be included as an available resource for Medicaid purposes. This language can be customized so that the grantor can remove and replace the trustee with the limitation that the grantor cannot ever be designated as the trustee.

Conclusion

Determining which tax-related provisions to include in a MAPT is very case specific. Careful thought should be given to what tax provisions will provide the best result for the particular client while achieving other objectives such as asset protection from creditors such as Medicaid.

Endnotes

1. I.R.C. §§ 671-679.
2. I.R.C. § 671.
3. *See* I.R.C. §§ 671-679.
4. I.R.C. § 673.
5. I.R.C. § 674.
6. I.R.C. § 674(b).
7. I.R.C. § 675.
8. I.R.C. § 675(4)(c).
9. I.R.C. §.1014.
10. I.R.C. § 677.
11. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, August 10, 1993, 107 Stat. 312.
12. I.R.C. § 2511.
13. I.R.C. § 2505.
14. https://www.irs.gov/newsroom/estate-and-gift-tax-faqs.
15. I.R.C. §§ 2036 -2038.
16. *Id.*
17. *See* https://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax.
18. I.R.C. § 1014.
19. *Id.*
20. I.R.C. § 2036(a).
21. I.R.C. § 121.
22. I.R.C. § 2038(a)(1).