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Income-Only Trusts: A Win-Win-Win Option in Estate Planning

When appropriate, income-only trusts can achieve the multiple objectives of preserving assets while minimizing tax liability, protecting assets against the possibility of long-term care costs, and retaining control for the grantor. This review of the income-only trust reminds us of the important factors that need to be considered to use this vehicle successfully.

By Billie M. Castle

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Most elderly clients hope to achieve multiple objectives through estate planning. They want to pass down their estate to their heirs with a minimum of tax liability, to be sure. But that usually constitutes only a beginning. Clients also want to protect assets against the potentially staggering costs of long-term health care. At the same time, they want to retain control over their assets to the greatest extent possible. An income-only trust offers the client an option through which he or she can achieve all of those objectives, adding another win to the proverbial win-win situation. Moreover, an income-only trust offers a particularly attractive alternative to simply transferring assets to heirs as outright gifts. Assets transferred to an income-only trust are preserved for heirs with the step-up in basis intact,[1] while income earned from the assets is taxed at the lower grantor rate.[2] In addition, assets transferred to an income-only trust no longer are considered a resource in determining eligibility for Medicaid benefits.[3] Finally, and for many clients, most importantly, the grantor of an income-only trust may also serve as trustee, retaining not only control over the manner in which assets are invested, but also a sense of security and dignity. Including inter vivos and testamentary special powers of appointment in the trust provisions adds further control, flexibility, and protection.

This article explores the use of income-only trusts in estate planning. It first reviews the basics of the income-only trust, including several important drafting considerations, and next details the advantages of an income-only trust in relationship to taxes, long-term health care planning, and control. Potential risks posed by estate recovery and the right to elect also are considered. Finally, the article offers some general guidelines to the elder law practitioner on when, and when not, to use income-only trusts.

The Income-Only Trust: A Review of the Basics

Income-only trusts offer a means by which clients may transfer assets while retaining the right to income earned from those assets. Typically, such income-producing assets as certificates of deposit, stocks, rental property, and mineral interests are transferred to income-only trusts. Nonetheless, income-only trusts may also include assets that do not necessarily produce income—a client's primary residence, for example. In that event, trust provisions must be drafted to specifically allow the trustee to retain non-income-producing assets.

Income-only trusts impose several conditions, so it is important that clients fully understand what is involved. Since transfers are irrevocable, clients must be aware that they, as well as their spouses, forever give up ownership of any assets transferred to the trusts. Neither the grantor nor the grantor's spouse may have any access whatsoever to the principal of the trust. This is particularly important if there is a possibility a client later could require Medicaid assistance in paying for long-term health care.[4] Grantors may name themselves as trustees, giving them the right to manage assets in the trusts as they see fit. As trustees, though, clients should realize that they take on fiduciary responsibilities to beneficiaries to manage assets in a prudent fashion.

Including inter vivos and testamentary special powers of appointment in the trust provisions adds a further measure of control and flexibility to income-only trusts. Trusts may be drafted so that either a grantor or trustee has an ability to distribute trust principal to a third party, usually the beneficiaries. An inter vivos special power of appointment vested in the grantor permits distribution to third parties during the life of the grantor. Since trust beneficiaries are typically children or other family members, this important provision serves as a safety valve of sorts, in the event the family needs trust assets prior to the death of the grantor, for example. A testamentary special power of appointment permits the grantor to change the ultimate beneficiary of the trust by exercising the power of appointment in a will. This provision gives the grantor the ability to respond to unforeseen circumstances, such as the death or unexpected disability of a child. Regardless of how the trust is drafted, it is essential that the grantor and spouse have no access to principal. If a grantor appoints a trustee other than himself, it is also important to prohibit the trustee from distributing principal to himself in order to avoid adverse estate tax consequences. If the trustee predeceases the grantor, the value of the trust assets might be included in the estate of the trustee for federal estate tax purposes.[5]

Advantages of an Income-Only Trust

An income-only trust offers several advantages for tax savings, long-term health care planning, and control, particularly when compared to outright gifts to children.

One of the greatest tax advantages results from the fact that an income-only trust is a grantor trust. Because income is distributed to the grantor, income tax is paid by the grantor at the grantor's tax rates rather than by the trust at the much higher trust rate.[6] The exact tax savings depend, of course, on the amount of income earned by trust assets. By way of comparison, annual income earned by a trust exceeding $8,900 is taxed at a trust rate of 39.6 percent.[7] But an individual would have to earn more than $300,000 annually to ascend to the 39.6 percent income tax bracket.[8] As a grantor trust, an income-only trust also offers ease of administration. Income is reported to the grantor, eliminating the need for separate taxpayer identification numbers and tax return forms.[9] Because the grantor reserves the right to income from the income-only trust, the entire value of the assets is included in the grantor's estate for federal estate-tax purposes.[10] Consequently, an income-only trust might not be appropriate for clients with taxable estates. But for the vast majority of clients who do not have taxable estates, the trust serves as an advantage. Since trust assets are included in the estate of the grantor, the estate receives a step-up in tax basis to the fair market value of the assets at the grantor's death.[11]

This offers a substantial benefit over outright gifts to heirs, especially when such assets as property or stocks have appreciated significantly. Transferring a primary residence to an income-only trust in which the grantor retains a testamentary special power of appointment maintains the capital gains exclusion on the sale of that residence.

In addition to tax benefits, an income-only trust offers a particularly advantageous estate planning technique for clients who want to protect assets against the potentially catastrophic costs of long-term health care. Assets transferred to an income-only trust are no longer considered a resource in determining eligibility for Medicaid assistance.[12] The extent of this protection depends on the value of the assets transferred to the trust and the time elapsed between the transfer and application for Medicaid benefits. Transfers into an income-only trust are deemed "transfers without fair consideration" in other words, a gift that creates a period of ineligibility for Medicaid benefits.[13] The exact period of ineligibility is calculated by dividing the total value of the assets by a state "divisor," the average monthly cost of long-term health care in the state in which the client applies for Medicaid.[14]

There is an important distinction involving assets transferred to trusts, however. While the maximum period of ineligibility, or "look-back period," created by outright gifts is three years, the look-back period for transfers into trusts can extend to a maximum of five years.[15] This assumes, of course, that a Medicaid application is not filed during a period of ineligibility. Applicants who file during a period of ineligibility are unable to take advantage of the look-back provisions. Income-only trusts may still be used for some clients who require immediate health care, protecting at least a portion of the assets while privately paying for care during the period of ineligibility created by transfers to the trust. Generally, however, income-only trusts are far more advantageous to clients who don't anticipate the need for long-term health care for at least three to five years.

For many clients, the chief advantage of an income-only trust is the control and protection it affords, particularly when compared to simply transferring assets outright to children. To reiterate, grantors of income-only trusts may name themselves as trustees, giving them the right to manage assets in the trusts as they see fit. In the process, they avoid problems that can arise from transferring assets to children. While most clients certainly trust their adult children, transfers to them can expose assets to risks from creditors, marital difficulties, or addictive behaviors. Creditor claims against children may attach to transferred assets including, in the worst-case scenario, the primary residence in which a client still lives, yet no longer owns. If children encounter marital difficulties, transferred assets can become entangled in divorce, alimony, and child support, ultimately affecting the children's distribution or payments. Assets transferred to a child who, unbeknownst to the parent, suffers from addictive behavioral problems could be squandered because of drug or alcohol abuse or gambling.

Risks of an Income-Only Trust

While income-only trusts offer many advantages, several risks are also involved, namely those posed by estate recovery and the right to elect, two increasingly popular means by which states recoup the cost of long-term care for Medicaid recipients. In some states, an income-only trust does not protect assets against efforts to recoup Medicaid benefits through estate recovery.[16] Other states are revising regulations to similarly allow for recovery of non-probate assets. In addition, some states force Medicaid recipients to assert their rights to elect against the estates of their spouses, including assets held in income-only trusts.[17]

Federal Medicaid regulations define "estate" in two ways: a narrow interpretation that includes only probate assets and a much broader interpretation that includes any assets in which the deceased had an interest at the time of death, including assets transferred to trusts.[18] Federal regulations require that states implement an estate recovery program, but permit states to choose which definition of estate to use.[19] Many states use the broader definition, and it is likely that more states will follow suit.

Practitioners and their clients must be aware of this distinction and must consider the ramifications. In states that use the narrow definition of estate, the assets of an income-only trust are generally deemed non-probate assets and therefore not subject to estate recovery. In states that use the broader definition, however, those same assets could be subject to estate recovery. Still, income-only trusts may be used in states that follow the broader definition. In fact, income-only trusts actually work well when established for the non-institutionalized, or "community" spouse of a Medicaid recipient. The risk, of course, is that the community spouse ultimately could require Medicaid assistance as well. In drafting an income-only trust to avoid estate recovery, it is also important that trust assets not be made available to pay the decedent's creditors. If assets are available to creditors of the estate, those assets could be subject to Medicaid estate recovery.

In addition to recouping Medicaid expenses through estate recovery, states are permitted to force Medicaid recipients to assert their rights to elect against the estates of their spouses.[20] Increasingly, states are doing just that, posing another risk in establishing an income-only trust. Assets held in an income-only trust that normally would go to the beneficiaries upon the death of a community spouse must go instead to the institutionalized spouse, disqualifying him or her from Medicaid benefits in the process. There is little choice, however: Failure to elect constitutes a transfer without fair consideration, creating a period of ineligibility for Medicaid benefits.[21] Some states allow a surviving spouse an elective share to be satisfied out of only probate assets, meaning assets held in an income-only trust are not subject to the right to elect.[22] Other states, however, allow an elective share against the augmented estate, which can include assets in which the decedent retained a right to income.[23] It is essential that practitioners consider the laws in their states before they establish an income-only trust.

To Use or Not to Use an Income-Only Trust: Some Practical Guidelines

There are no hard and fast rules upon which an elder law practitioner may rely when considering whether or not to establish an income-only trust for a client. That decision depends entirely upon the client and his or her unique situation. There are, however, some general circumstances in which income-only trusts serve as an advantageous estate planning technique. Conversely, there are circumstances in which an income-only trust probably should not be established.

It has been my experience that income-only trusts work best within the context of long-term planning for married couples with differing degrees of health and income. For example, one spouse might enjoy relatively good health and a long life expectancy. Tragically, the other faces a slowly degenerative medical affliction, such as Parkinson's or Alzheimer's disease. In addition, the ill spouse receives more income than the other spouse, perhaps from a pension with benefits that end at death. There is a strong likelihood that one spouse will require long-term care, but there is still ample time to plan for that inevitability. An income-only trust provides a source of continued income while protecting assets against long-term care costs and avoiding the loss of control and risks associated with outright transfers to children. Income-only trusts also work well for married couples that enjoy good health, but still want to protect assets against the possibility that long-term care could be required.

While income-only trusts often offer an excellent planning technique, there are circumstances in which they probably should not be used or for which other options are more appropriate. Generally, income-only trusts do not work well for what I term crisis planning: A client requires long-term health care in the immediate future or has relatively limited resources, and there is little likelihood he or she ever will leave the health care facility. In that scenario, it is probably best to simply privately pay for care and transfer assets outright until Medicaid eligibility requirements are met.

There is also a danger in establishing income-only trusts for clients who earn a substantial retirement income and either live in or plan to move to states that impose an income cap for Medicaid eligibility. In Colorado, for example, individuals who earn more than the income cap cannot qualify for Medicaid assistance.[24] In some cases, setting up an income-only trust could push the client's monthly income above the income cap.

Conclusion

Obviously, income-only trusts are not appropriate for every elderly client. Furthermore, practitioners must take care in drafting income-only trusts even when they are deemed appropriate. Still, an income-only trust offers an excellent estate planning technique to achieve the multiple objectives of preserving assets while minimizing tax liability, protecting those assets against the possibility of long-term care costs, and retaining control. Used in the right circumstances, an income-only trust truly provides a win-win-win situation.

Endnotes

1. *See* I.R.C. § 2036; I.R.C. § 1014(b)(9).
2. *See* I.R.C. § 674.
3. 42 U.S.C. § 1396p(d)(3)(B).
4. *See id.*

5. *See* I.R.C. § 2041; *see also* Treas. Reg. § 20.2041-1(b)(1).

6. *See* I.R.C. § 674.

7. I.R.C. § 1(e)(2).

8. *See* I.R.C. § 1(d).

9. *See* I.R.C. § 674.

10. *See* I.R.C. § 2036.

11. I.R.C. §§ 1014 (a), (b)(9).

12. *See* 42 U.S.C. § 1396p(d)(3)(B).

13. *See* 42 U.S.C. § 1396p.

14. 42 U.S.C. § 1396p(c)(1)(E)(i)(II).

15. 42 U.S.C. § 1396p(c)(1)(B)(i).

16. 42 U.S.C. § 1396p(b)(4)(B).

17. *See* HCFA Transmittal No. 64, State Medicaid Man., pt. 3 § 3257.B(3) (1994). In Colorado, *see* Colo. Dept. of Health Care Policy & Financing Staff Man., v. 8, § 8.110.52(D)(4) (2000).

18. 42 U.S.C. § 1396p(b)(4).

19. 42 U.S.C. §§ 1396p(b)(1), (b)(4).

20. *See* HCFA State Medicaid Man., *supra* note 17.

21. *Id.*

22. *See generally* A. James Casner & Jeffrey N. Pennell, Estate Planning (6th ed. 1998).

23. *Id.*

24. Colo. Dept. of Health Care Policy and Financing Staff Man., v. 8, § 8.110.52(B)(5)(a).