Why a Non-Grantor Trust May Be the Best Bet for VA Aid and Attendance Planning

By Robert C. Anderson, CELA, LLM, Taxation

In assessing countable assets for VA Aid and Attendance, the VA does not penalize gifts made before the veteran applies for the benefit. However a recent change to the VA's adjudication manual clarifies that retaining income from the gift will not work. If appreciated assets, such as land, stocks, or mutual funds need to be transferred to an irrevocable trust in order to exempt them from VA countability and provide for a stepped-up tax basis, the use of an irrevocable non-grantor trust with a retained testamentary special power of appointment may be the safest canoe to paddle.

PROBLEMS WITH USING A GRANTOR TRUST

The first problem with all forms of irrevocable grantor trusts is that the veteran gets taxed on the Trust's taxable income even if the veteran does not receive it. The VA may pick up the income when it taps into IRS records and conclude the underlying assets creating the income still belong to the veteran. This may lead to a VA denial of Aid and Attendance.

The second problem relates to the income-only type of irrevocable grantor trust. In such a grantor trust, the veteran retains the right to receive income. While such a trust will in most states pass Medicaid muster, it is now clear due to a recent change to the VA's adjudications manual[1] that when a veteran retains the rights to income, the assets creating the income will continue to be countable for VA Aid and Attendance.

The VA manual change issued on May 20, 2011 states that the property given away will still be considered to belong to the veteran if the veteran retains "any rights to the property or income from the property" (paraphrasing). The manual change clarifies the requirement in the applicable federal regulation at 38 C.F.R. §3.276(b) that gifts must be complete in order to be considered to no longer belong to the veteran.

The author wishes to acknowledge the contribution of NAELA attorney, Rick Law, in preparing this article.

This manual change is consistent with the most applicable VA Office of General Counsel opinion in O.G.C. 15-92, even though the opinion concerns the treatment of a non-trust life estate. In O.G.C. 15-92, the O.G.C. disregarded a veteran's widow's transfer of non-homestead lands because she retained a life estate "including the right to all income from the properties." Incredibly, the O.G.C. ruled that not only was the value of the life estate countable, but so was the transferred remainder interest! Based on this rationale, the principal of an irrevocable income-only trust would also be countable.

DESIGNING A NON-GRANTOR TRUST

Because of the problems concerning grantor trusts, the author recommends the use of a *non-grantor simple irrevocable trust* in which no income is payable to the veteran. In client discussions, my firm refers to this trust as a Veterans Eligibility Trust (VET).

In setting up a VET, the veteran is the Settlor, retains no right to amend or revoke, and transfers assets into the trust. Someone other than the veteran serves as Trustee. Certain family members or others are beneficiaries, who will be entitled to receive mandatory trust income. It is critical that the veteran has no right to receive any income or principal, nor should the veteran retain any other right with the exception of a *testamentary special power of appointment* (SPA). Since the veteran has no access or control over trust assets, the assets in trust will be exempt from VA countability net worth rules as described in 38 C.F.R §3.275(b).

For tax purposes in a VET, the veteran is a mere nominal trust grantor and will not retain any powers which will cause a trust to be treated as a *grantor trust*.[2] The trust will therefore be treated as a non-grantor trust.[3] The non-veteran beneficiaries will be entitled to receive mandatory interest, dividends, capital gains, and other income. As a result, the beneficiaries will be taxed on trust income, and the trust will be treated as a simple trust for income tax purposes.[4] In this way, trust taxable income will not be reported on the veteran's tax return, nor will income be taxed to the trust at highly compressed rates.[5] The non-veteran beneficiaries will be able to use the trust's income to cover their tax liability on the taxable income.

In order to avoid gift tax reporting and capture a stepped-up tax basis for appreciated capital assets, the veteran will retain a testamentary SPA.[6] A *testamentary* SPA is one that is exercised in a Last Will and Testament which is effective only after death. Since it is possible that a VA adjudicator may challenge eligibility if a veteran retains a lifetime SPA, a veteran's retained testamentary SPA is a safer strategy.[7]

Some practitioners argue that the use of even a *testamentary* SPA is risky in that it is still a retained power and could be considered a "right of control over the property [given away]" which federal regulation §3.276(b) prohibits. However, the author believes that such a view can be discounted in light of the May 20, 2011 adjudication manual change and O.G.C. 15-92's stress on only those retained rights which create "any rights to the property" or "the right to income." A *testamentary* SPA creates no right to the property owned by the trust or income while the veteran is alive or after death. Moreover, O.G.C. 64-91 makes it clear that once assets are placed into a trust in which the veteran is not serving as Trustee the veteran has no control over the "property" in the trust "except to the extent trust assets may have been allocated for the veteran's use." In a VET, the trust assets are not allocated for the veteran's use.

In order to make it clear that the vet-

1 M21-1MR, Part V, Subpart iii, Chapter 1, Section

2 I.R.C. §673-678

3 Non-grantor trusts are taxed under I.R.C. §§644-667

4 I.R.C. §§651

5 I.R.C. §1(a)-(e)

6 A retained testamentary special (or limited) power of appointment will prevent a gift from being completed for gift tax purposes under Treas. Reg. §25.2511-2(b) and result in inclusion for estate tax purposes under I.R.C. §2036(a)(2) and 2038 and thus confer a step-up under I.R.C. §1014(b)(4).

7 *See Doherty v Dir. Off. Of Medicaid*, Mass. App. Ct., No. 08-R939 (March 2009) as it relates to Medicaid qualification.

eran's retained *testamentary* SPA will not cause the veteran to report tax on the trust's income by triggering grantor trust status, the exercise of the testamentary SPA should require the advance consent of a non-veteran trust beneficiary.[8]

A sample provision that creates an effective *testamentary* SPA provides: "Grantor, with the advance consent of any primary beneficiary designated herein, may designate or appoint in his or her Last Will and Testament trust property including corpus to any individual(s) other than himself/herself, his or her estate, his or her creditors, or the creditors of his or her estate."

The author recommends that if the veteran requires more income to cover care costs or other expenses, the veteran should consider the purchase of an immediate income annuity which converts countable assets into an income stream in the veteran's name rather than a trust which provides income to the veteran.

CONCLUSION

Navigating in the murky waters of the VA and the tax code is a real challenge. The use of a non-grantor trust with a testamentary SPA may be the safest canoe to use.

8 By requiring the consent of another to designate or appoint, the grantor trust-triggering provision of I.R.C. §674(a) is avoided; and to be extra sure it is important to add a clause which prevents the Trustee from accumulating income (see Treas. Reg. 1.674(b)-1(b)(3).

Special Needs Trust Idiosyncrasies

By Cynthia L. Barrett

INTRODUCTION TO SPECIAL NEEDS TRUST PLANNING

Special needs planning is triggered by a person's health problems. A special needs trust (SNT) is usually part of the planning, designed to allow the potential beneficiary's public funded health coverage (that is, needs-based Medicaid) to continue despite the existence of a trust for the person's benefit. The special needs trust funds are distributed to supplement state and federal cash income and medical coverage programs. If the trust terms fit the public program rules, the trust is not considered an "available resource" so as to disqualify the beneficiary.

The lawyer usually represents a family member or friend setting up a trust for the chronically ill beneficiary. Lawyers also represent a trustee of such a trust during administration – the focus of these materials today.

The toughest special needs trust administrative situations involve:

- incapacity and disability of a trust beneficiary (often giving rise to chaotic life and care circumstances), and/or
- inordinate health care and supportive care costs for that beneficiary.

Supportive services (also known as long term care) are not provided to any great extent by either private health coverage or Medicare. Some disabled individuals need day to day assistance to live semi-independently in a home or apartment. Family members and friends provide much of the needed support services, often sharing a residence with the disabled person. But some disabled individuals pay privately for supportive services in the home or in a licensed facility, and some depend on Medicaid to pay for in-home or facility supportive services.

The trustee of any discretionary or mandatory support trust might spend down the trust corpus for health care premiums and uninsured costs, including supportive services in the home or licensed facility care. A discretionary or mandatory support trust may, in some states, disqualify the beneficiary from Medicaid coverage. However, no trust disqualifies the beneficiary from Medicare coverage. Most trusts are not written as special needs trusts. Yet if the beneficiary is, or becomes, ill or cognitively impaired, and loses access to job-related health insurance and needs supportive services, *then the trustee should evaluate whether and when that beneficiary might qualify for public benefits – a classic special needs situation*. Part of routine trust administration is altering trustee distributions, and perhaps changing the trust itself, to respond to a beneficiary's deteriorating health and health plan coverage changes.

Some apparent special needs trusts are drafted in a confusing way. A purported special needs trust may even be drafted in an administratively impossible way — like a testamentary third party trust I discovered where the drafting lawyer included an unnecessary Medicaid payback clause *and* explicitly placed the decedent's home in the trust declaring the parent/testator's intent that the adult developmentally disabled child continue to live in the home, without providing a source to fund either the ongoing expenses of the home or needed in-home supportive care.

SNT ADMINISTRATION IDOSYNCRACIES

All trustees must perform the usual trustee duties: carry out the terms of the trust, remain loyal to the beneficiary, invest trust assets responsibly, maintain books and records, avoid self-dealing, and account to the beneficiary and the court. Each state has adopted statutes describing trust operation, often some version of the Uniform Trust Code.

How are the usual administrative duties affected by the circumstances of a special needs trust?

1. SNT Distributions Affected by Health Condition

The chronic illness and potential or current disability of a special needs trust beneficiary always affect how distributions from the trust are determined, and what

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