By Mark D. Munson, CELA, CAP

# Medicaid Planning Trusts, Gift Tax, and Estate Tax

***Medicaid planning trusts (MPT) are irrevocable trusts drafted in such a way to meet the "No Circumstances of Payment Test" required by 42 USC § 1396p(d)(3)(B)(i) and (ii). It can mean different treatment in different states since each state can interpret the meaning of federal law regarding its own Medicaid program.***

Medicaid planning trusts (MPT) are irrevocable trusts drafted in such a way to meet the No Circumstances of Payment Test required by 42 USC §1396p(d)(3)(B)(i) and (ii). It can mean different treatment in different states since each state can interpret the meaning of federal law regarding its own Medicaid program. Still, any interpretation cannot be "more restrictive" than the federal law itself (whatever it is). It is generally agreed and accepted that the No Circumstances of Payment Test means the terms of an MPT must require that the trust creator, usually the client, has no beneficial interest in the MPT or only an income interest in the MPT and is not, under any circumstance, a beneficiary of the MPT's principal.

Mark D. Munson, CELA, CAP, is this issue's Featured Member. He focuses his practice in the areas of elder law, public benefits (including special needs trusts), estate and trust planning, and taxation.

One tax planning objective often desired by clients who establish an MPT is that assets within the irrevocable trust receive a stepped-up basis upon death. Stepped-up basis increases the tax cost basis of the underlying trust assets to the fair market value of those assets as of the date of death. Stepped-up basis is an income tax concept since it affects the taxation of gain (or loss) upon the sale of an asset. Please see Internal Revenue Code (IRC) §1014.

A common way of achieving a stepped-up basis in an MPT is having the client retain a testamentary limited/special power of appointment. The retained power of appointment allows the client to change the remainder beneficiaries' identity compared to the existing remainder beneficiaries named in the MPT document. Besides the income tax benefit, clients who establish MPTs often want to include this power. Hence, they retain an element of control over who will receive the irrevocable trust's assets upon passing. To ensure a retained power does not make the trust assets available to the client and disqualify them from Medicaid, it is essential to understand your state's interpretation of federal Medicaid law regarding availability of assets.

This begs the question of the treatment of an MPT with such provisions for federal gift and estate tax purposes. First, from the gift tax perspective, determine whether the MPT is an irrevocable income-only trust or not. If so, contributions to the trust would be taxable gifts under IRC §2702. An MPT is *not* a qualified interest under IRC §2702, which causes the client's right to the income of the MPT to be valued at $0, while 100% of the assets transferred to the MPT by the client is a taxable gift for federal gift tax purposes.

If the MPT is not an irrevocable income-only trust, the client retains no beneficial right to receive income or principal from the trust. Contributions to such a trust would presum-


ably be taxable gifts under IRC §2511. Chief Counsel Advice Memorandum 2012208026 is instructive as it determined that contributions to such a trust are completed gifts for federal gift tax purposes. Suppose the client's objective is to have contributions to the MPT treated as incomplete gifts for federal gift tax purposes. Then, the client should retain a lifetime limited/special power of appointment or veto powers over distributions. The client's retaining a limited power of appointment in the trust or veto powers of distributions makes the transfer to the trust an incomplete gift for federal gift tax purposes. In that case, the client should nonetheless file a United States gift tax return (i.e., IRS Form 709) per Treas. Reg. §25.6019-3(a).

Suppose the contribution of an asset by a client to an MPT is a taxable gift (or a completed gift) for federal gift tax purposes. In that case, the client must file a gift tax return (IRS Form 709). A filed gift tax return is evidence of a completed gift. It also provides proof of the client's donative intent and that the client has parted with dominion and control as to the assets contributed to the MPT. In blending Medicaid planning with gift and estate tax planning, the goal is to remove assets from the client's Medicaid estate while not removing assets from the client's taxable estate.

Is it still possible for assets contributed to a MPT to receive a stepped-up basis upon the client's death if transferring assets to the MPT is a completed taxable gift for federal gift tax purposes? As long as the client retains a power over the assets within the MPT and those assets are included within the client's taxable estate, the assets in the trust will receive a stepped-up basis for capital gains upon the client's passing per IRC §1014(b)(9).

If the client retains a testamentary limited/special power of appointment over the assets within the MPT, there is no completed gift for federal gift tax purposes. The trust assets become part of the client's taxable estate and are eligible for a stepped-up basis. It is a common strategy (as long as the power does not cause assets within the MPT to be deemed available assets in your state).

Also, a retained testamentary limited/special power of appointment over the assets in the MPT by the client causes the assets within the MPT to be included in the client's taxable estate under IRC §§2036 and 2038. As for IRC §2036, if the client retains "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" for the life of the client, the MPT assets become part of the client's taxable estate upon the client's passing. Retaining a testamentary limited/special power of appointment may cause inclusion in the client's taxable estate under IRC §2036 and receive a stepped-up basis under IRC §1014(b)(9).

Under IRC §2038, if the client retains a power, which can be exercised by the client alone or with any other person, to alter, amend, or revoke, including relinquishing such power within three years before the date of death, during the client's lifetime then such a retained power will cause the assets within the MPT to be included in the client's taxable estate upon the client's passing. Retaining a testamentary limited/special power of appointment results in including the assets in the client's taxable estate under IRC §2038 and a stepped-up basis under IRC §1014(b)(9).

Is there a remedy if assets contributed to an MPT are subject to federal gift tax (upon the client's contribution of assets to the MPT) and federal estate tax (upon the client's passing)? Fortunately for taxpayers, the answer is yes. If MPT assets are subject to federal gift and estate tax, the value of those gifts is removed from the federal estate tax calculation under IRC §2001(b). This section defines the term adjusted taxable gifts as "the total amount of the taxable gifts (within the meaning of IRC §2503) made by the decedent after December 31, 1976, *other than gifts which are includible in the gross estate of the decedent* [emphasis added]."

For most clients, contributions to a MPT are subject to federal gift tax, and federal estate tax is of no concern because the current unified gift and estate tax exemption is so high that it will not affect them. The unified gift and estate tax exemption amount for 2021 is $11.7 million per individual and is $12.06 million for 2022. The unified gift and estate tax exemption amount is indexed for inflation, so it increases annually. The current unified gift and estate tax exemption base amount is $10 million. In 2017, the unified gift and estate tax exemption base amount was increased from $5 million, which amount was enacted in 2010. On January 1, 2026, the current unified gift and estate tax exemption base amount will revert to $5 million, indexed for inflation, unless extended by Congress. On that date, the unified gift and estate tax exemption amount is likely to be $6 to $7 million.

In working with clients who want to create and fund an MPT, remember, consider, and adhere to the income, gift, and estate tax rules besides the Medicaid rules, and usually, clients may well have their cake and eat it too! ■