

# **INCOME ONLY TRUSTS, HAVING YOUR CAKE AND EATING IT TOO**

by Thomas D. Begley, Jr.

Prior to the enactment of the Deficit Reduction Act of 2005 (DRA), there was a lookback of 3 years for transfers to individuals and 5 years for transfers to trusts. Most clients engaged in Medicaid planning were reluctant to assume the risk of paying for care in years 4 and 5, and preferred to transfer assets to children, rather than to an Income Only Trust. With the enactment of the DRA and the extension of the lookback period for transfers to individuals to 5 years, the lookback is now the same for transfers to individuals and trusts and it makes sense to revisit the idea of making transfers to Income Only Trusts.

Income only trusts present a wonderful planning opportunity for elder law attorneys in a number of situations. These trusts give the parent a greater feeling of control than do outright transfers to children. They serve to minimize risk associated with transfers of assets to children, and in some situations present opportunities for tax planning.

To know when to use an income only trust, it is necessary first to understand the rules relating to transfers to and from the trust and how the penalty is calculated. Estate recovery and the elective share problem are among the other factors that must be considered in income only trust design and use.

## **1. Background**

Following enactment of OBRA-93, there was some confusion as to when the three-year lookback or five-year lookback applied, and whether the penalty applied to transfers to or from trusts. OBRA-93 contained language that could be construed to make the assets in an income only trust "available."<sup>1</sup> On December 23, 1993, Sally K. Richardson, Director, Medicaid Bureau, Health Care Financing Administration (HCFA), in a letter to Ellice Fatoullah, Esq., resolved many of these issues. (See "Income Only Trusts Resuscitated Under HCFA Interpretation of OBRA-93," *The Elder Law Report*, Vol. V, No. 7, February 1994, page 1). The main points of that letter were:

- (1) If there are any circumstances under which either income or trust corpus could be paid to the individual, then actual payments to the individual of either income or corpus are deemed "income" for Medicaid eligibility purposes.
- (2) If trust corpus could be paid to an individual but is not, such asset is deemed an available resource for Medicaid eligibility purposes.

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<sup>1</sup>42 U.S.C. § 1396p(d)(3)(B).

- (3) If no portion of the trust corpus may be distributed to an individual (i.e., an “income only trust”) then no portion of the trust is deemed a resource of the individual for Medicaid eligibility purposes.
- (4) If some portion of the irrevocable trust corpus could be paid to an individual, and assets are transferred from the trust to someone other than the individual, then the individual is subject to the Medicaid three-year lookback.

This left open the issue of whether a lookback applied to transfers to or from the income only trust. Even HCFA was not sure which interpretation was correct. (Q&A 83, Summary of Verbal Q&As from HCFA Central to the Regions, November 4, 1993.)

In a February 25, 1998, letter to attorney Dana E. Rozansky of Begley, Begley & Fendrick, Robert A. Streimer, Director, Disabled and Elderly Health Programs Group at HCFA’s Center for Medicaid and State Operations, clarified the rules concerning lookbacks and penalties for various types of trusts:

## **2. Has There Been a Transfer?**

The first issue to be addressed in analyzing whether to transfer to a trust is whether or not there has been a transfer that would be subject to the Medicaid transfer of asset provisions, including the lookback provisions.

### **2.1. Transfers to a Revocable Trust**

To understand the lookback and penalty provisions, it is necessary first to know when a transfer has taken place. The key is whether the asset remains available after the transfer. Therefore, if assets are transferred to a revocable trust, there is no transfer of assets, because the grantor still retains control over them. They remain available resources, according to the Streimer letter.

### **2.2. Transfers from a Revocable Trust**

When assets are transferred from a revocable trust to a person other than the trust beneficiary, the transfer is subject to a five-year lookback period. It is understood that, in this context, the reference to the trust beneficiary is to the grantor of the trust. In other words, transfers to third parties from a revocable trust are subject to the transfer of assets penalties.

### **2.3. Transfers to an Irrevocable Trust**

To the extent that assets transferred to an irrevocable trust are no longer available to the grantor, the transfer is subject to the transfer of assets penalties. To the extent that transferred assets remain available to the grantor, no transfer has taken place and there is no transfer of asset penalty.

## 2.4. Transfers from an Irrevocable Trust

When transfers are made from an irrevocable trust, in which assets were not available to the grantor, to third parties, no penalty is imposed because the penalty was imposed when the assets were transferred into the trust.

## 2.5. Transfers to an Income Only Trust

Transfers to an income only trust are considered available only to the extent of the income earned. Transfers of the assets to the trust are subject to a five-year lookback.

## 2.6. Penalty

The penalty for transfers to or from trusts is calculated in the same manner as the penalty for any other transfer. It is computed by dividing the fair market value of the transferred asset by the statewide monthly average of the lowest semiprivate room rate for Medicaid-certified nursing facilities (the "Divisor"). For example, a man living in a state that has a Divisor of \$6,000 transfers \$60,000 to his children. The penalty is calculated as follows:

$$\begin{array}{r} \div \quad \$60,000.00 \quad \text{Amount Transferred} \\ \quad \quad \underline{6,000.00} \quad \text{Divisor} \\ \quad \quad \quad 10 \quad \quad \text{Months of Ineligibility} \end{array}$$

Assuming that he made a \$60,000 transfer to an income only trust, the penalty would be calculated in the same manner and there would be the same 10-month period of ineligibility.

## 2.7. Summary

To summarize, an income only trust is an irrevocable trust in which the grantor retains the right to receive income only and has no access to principal under any circumstances. Therefore, when assets are transferred into the trust, there is a five-year lookback, and the penalty is calculated in the usual manner. When assets are transferred from an income only trust to third parties, that transfer is not subject to a lookback or penalty, because the penalty was imposed on the transfer of the assets into the trust.

## 3. When is an Income Only Trust Useful?

### 3.1. Control

There are a number of situations in which transfers to an income only trust should be considered in lieu of transfers to children.

Some clients are relatively healthy but are aging and are concerned about the potential cost of their long-term care. Other clients have early Alzheimer's disease; while they are not convinced that they will ever require nursing home care, they would like to do

some planning. For example, an 85-year-old woman, who is in relatively good health or is in the early stages of Alzheimer's disease and who has \$150,000 in assets, wants to preserve a portion of her estate for her children. By transferring the assets to an income only trust, she has the feeling that she has more control over them, since income is being paid directly to her rather than through her children. The client feels a greater sense of independence because of this direct payment.

### 3.2. Risk Avoidance

Income only trusts are a risk avoidance strategy. If an elderly parent transfers assets to children, certain risks must be anticipated.

- *Claims of Creditors.* If the parent makes outright transfers to the children, the claims of the creditors of the adult children could be satisfied through the parent's assets. For example, if a child is a poor money manager and habitually late in making payments, the assets being held by that child on behalf of the parent would be subject to claims of creditors. Similarly, if the child is responsible but is involved in an automobile accident and the damages exceed the amount of the child's insurance, the parent's assets being held by the child would be subject to the claims of the plaintiff in the lawsuit.

If the parent makes a transfer to a trust naming as child as trustee and a creditor makes a claim against that child, the assets in the trust are not subject to the claims of the child's creditors even if the child is the trustee of the trust. The assets belong to the trust, not to the trustee.

- *Divorce.* If a child to whom assets are transferred is subsequently divorced, the transferred assets may become subject to a claim of equitable distribution. While hornbook law dictates that assets transferred from a parent to a child are not subject to equitable distribution, practitioners in the field of family law indicate that judges often find ways to give additional assets, other than the transferred assets, to the other spouse. In addition, the assets transferred could affect alimony or child support rights or obligations.

If assets are transferred to an income only trust and the child, even one serving as trustee, becomes ensnared in a divorce action, the opposing spouse is not entitled to make a claim against assets in the trust, because those assets belong to the trust not the child who is beneficiary or even trustee of the trust.

- *Bad Habits.* If a parent transfers assets to a child who is a gambler, drug addict, alcoholic, or spendthrift, the assets may be squandered and no longer available to the parent.

If assets are transferred to a trust and a child is named as beneficiary of the trust who is a gambler, drug addict, alcoholic, or spendthrift, the assets cannot be squandered until the death of the parent who is the income beneficiary. In fact, the trust could be designed to continue after the death of the parent income beneficiary and limit access of the child with bad habits to the income and principal under such terms and conditions that the grantor parent deems to be appropriate, or could skip the child with bad habits and pass to grandchildren either outright or in trust. It would not be good practice to name the child with bad habits as the trustee of the trust.

- *Financial Aid.* If the adult child to whom assets are transferred is applying for financial aid on behalf of a college student, the amount of aid may be reduced or eliminated because the transferred assets are in the adult child's name.

An income only trust can be structured so that the adult child would have no disqualifying interest in the trust and financial aid would be available to the grandchildren applying for financial aid. This would be true even if the adult child were the trustee.

### **3.3. Tax Considerations**

Tax implications are another reason to consider an income only trust.

- *Income Tax.* Usually, the elderly client is in a lower income tax bracket than his or her children. If assets are transferred to the children to hold for the parent, the income earned on those assets is taxed to the children at their higher marginal tax rates. Through use of an income only trust, income will be paid directly to the elderly parent, and the tax will be paid at the parent's lower tax rates. (A converse strategy may be indicated where the parent is trying to become eligible for a pharmaceutical plan or a utility reimbursement program and needs to reduce income in order to qualify.)

By structuring the income only trust as a grantor trust, the parent will be taxed on the income at the parent's lower tax rate.

- *Section 121 Exclusion from Capital Gains Tax on Sale of Principal Residence.* As a general rule, there is an exclusion from gross income for the sale of a principal residence, if the property was owned and used by the taxpayer as the taxpayer's principal residence for two of the five years preceding the date of the sale. The amount of the gain excluded is \$250,000 for a taxpayer filing individually and \$500,000 for taxpayers filing jointly. In the case of married couples, the ownership requirement can be met by either spouse, but both spouses must meet the use requirement and neither spouse can have claimed the exclusion during the two year period ending on the date

of the sale. If a principal residence is transferred to children who sell the home, the principal residence exclusion is lost. If a principal residence is transferred to an income only trust, the trust can be designed to preserve the Section 121 exclusion.<sup>2</sup>

*Capital Gain.* If a parent transfers highly-appreciated assets to children, the transfer is subject to carryover basis rules.<sup>3</sup> When the child sells the appreciated assets, the child may pay significant capital gains tax. If the highly-appreciated assets are transferred to an income only trust, the trust can be structured so that the children receive a "step up" in basis on the death of the grantor parent.<sup>4</sup> The step up is scheduled to be substantially modified in 2010. Beginning in 2010 rules providing for the step up in basis are repealed.<sup>5</sup> In place of the step up rule, a modified carryover basis rule takes effect. Recipients of property transferred at the decedent's death will receive a basis equal to the lesser of the adjusted basis of the decedent or the fair market value of the property on the date of the decedent's death.<sup>6</sup> New Section 1022 allows an executor to step up the basis of assets owned by the decedent and acquired by the beneficiaries at the date of death. Each decedent's estate is generally permitted to step up the basis of assets transferred by a total of \$1.3 million.<sup>7</sup> This \$1.3 million limit is increased by the amount of unused capital losses, net-operating losses, and certain built-in losses of the decedent. In addition, the basis of property transferred to a surviving spouse can be increased by an additional \$3 million over the \$1.3 million general basis increase. Thus, the basis of property transferred to surviving spouses can be increased by total of \$4.3 million.<sup>8</sup> The \$1.3 million and \$3 million amounts are adjusted annually for inflation after 2010.<sup>9</sup> Whether or not the step up in basis rules are ever changed remains to be seen.

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<sup>2</sup>I.R.C. §121.

<sup>3</sup>I.R.C. §1015.

<sup>4</sup>I.R.C. §1014(b)(9).

<sup>5</sup>Section 541 of the Economic Growth and Tax Relief Act of 2001, Pub. L. No. 107-16 (June 7, 2001).

<sup>6</sup>I.R.C. §1022(a) as added by EGTRRA, 2001 Pub. L. No. 107-16 §542(a) (June 7, 2001).

<sup>7</sup>*Id.*

<sup>8</sup>*Id.*

<sup>9</sup>*Id.*

To ensure a step up in basis, the trust should be designed so that a limited power of appointment is reserved for the grantor.

#### **4. Aggregation of Transfers**

Are transfers to individuals and transfers to trusts aggregated for penalty calculation purposes? It would appear that if transfers are made to individuals and to trusts within the five-year lookback period, then all the transfers will be aggregated and the penalty will be imposed accordingly.

For example, assume that, in a state using a \$6,000-per-month divisor, \$60,000 is transferred to an individual and \$60,000 is transferred to a trust. Two years later, the individual applies for Medicaid. If the transfers were not aggregated, the transfer to the individual would result in a 10-month period of ineligibility and the transfer to the trust would also result in a 10-month period of ineligibility. It seems clear that those transfers would be aggregated and that the total transfer would be \$120,000, which would result in a 20-month period of ineligibility.

#### **5. Estate Recovery**

Whether or not estate recovery would apply to assets held in an income only trust would depend on whether the state used the narrow "probate" definition of an "estate" or whether the state used a broad definition of the term, which would include a living trust. Pennsylvania uses the narrow probate definition of estate. New Jersey uses the broad definition of estate, which includes an income only trust.

If the Medicaid recipient is a single individual and he or she transfers assets to an income only trust for his or her benefit, on the recipient's death the assets should not be subject to estate recovery, provided the state uses the probate definition of "estate." Given the same facts in a state with a broad definition of "estate," the assets in the trust would be subject to estate recovery. An argument could be made that the estate recovery statute applies only if there is a living trust in which the Medicaid recipient had a "legal interest" at the time of death. Since the beneficiary of a trust has an equitable rather than a legal interest, it could be argued that the assets in the trust are not subject to estate recovery. A more conservative view would be that the assets in the trust are subject to estate recovery in those states that broadly define "estate."

In the case of a married couple, if the income only trust was established for the benefit of the community spouse, there should be no estate recovery in a state with a narrow definition of an "estate" because the trust would not be a probate asset. In a state with a broad definition of the term, the trust assets also should not be subject to estate recovery because the deceased Medicaid recipient did not have a legal interest in the trust as of the date of death. Some states, including New Jersey, use the concept of tracing. For example, in New Jersey if the assets in the income only trust for the community spouse belonged to the institutionalized spouse within a five year period of being transferred to the trust, then for estate recovery purposes the state traces those assets and recovers from the trust on the death of the community spouse. In some states there is tracing even if the

assets were transferred by the institutionalized spouse to the community spouse more than five years prior to them being transferred to the income only trust.

If a potential Medicaid recipient establishes an income only trust in a state with a broad definition of "estate," a strategy would be to have the trustee make distributions from the trust to a third party prior to the application for Medicaid or, at least, prior to the date of death of the Medicaid recipient. Since the penalty would be calculated on the basis of the transfer to the trust, there would be no further penalty for the distribution from the trust and that distribution would protect the trust assets from estate recovery. New Jersey has recently taken an unofficial position that transfers from the income only trust are subject to the Medicaid transfer of asset penalty because there is a transfer of income. The amount of the transfer is calculated by multiplying the annual income by the actuarial life expectancy of the Medicaid recipient. This position is not based on any statute regulation or Medicaid communication. It appears to violate the Administrative Procedures Act.

However, care must be taken in drafting the trust so that trust assets are not available to pay debts of the decedent's estate. If assets are available to pay debts of the estate, they may be subject to Medicaid estate recovery.

## 6. Elective Share

Some state Medicaid agencies require that a Medicaid recipient who is predeceased by a spouse assert the recipient's right to an elective share against the estate of the predeceased spouse. Failure to do so is considered a transfer of assets subject to the Medicaid transfer penalty rules. If an income only trust provides for distribution to the children on the death of the community spouse, then these assets, in most states, would be subject to the state elective share statutes. The surviving Medicaid recipient would, therefore, have an obligation to assert his or her right to the elective share against the trust assets, and failure to do so would constitute a transfer for Medicaid eligibility purposes.

- *Pour-Back Trust.* A solution to this problem would be to draft the income only trust so that it is a pour-back trust, which, on the death of the community spouse, pours into the estate of the community spouse. The community spouse's will would be drafted with a special needs trust for the benefit of the Medicaid recipient with the children as trust remaindermen. If the trust provides that income from the testamentary special needs trust is paid to the Medicaid recipient, the recipient will have a present interest in the trust that should satisfy the elective share requirements. In states which have an income cap, this strategy must be carefully analyzed. Under HCFA Transmittal 64, trust rules do not apply to trusts established by a will.<sup>10</sup>
- *Special Needs Provision in Income Only Trusts.* An alternative solution would be to draft the income only trust so that upon the death of the community spouse sufficient funds were retained by the trustee

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<sup>10</sup>HCFA Transmittal 64 §3259.1A.

and administered pursuant to special needs trust language for the benefit of the surviving institutionalized spouse. There may be a question as to whether the excess funds transferred to the children would be subject to the Medicaid transfer of asset penalties. The issue is whether the distribution under the dispositive provisions on death section of the income only trust would qualify as a testamentary disposition.

In Pennsylvania, a distribution to a special needs trust will not satisfy the elective share. The distribution must be made outright to the institutionalized spouse in an amount equal to satisfy the elective share.

## **7. Tax Consequences**

### **7.1. Income Tax**

Since the income may be distributed to the grantor, the trust is a grantor trust and the income tax is paid by the grantor at the grantor's tax rates, rather than by the trust at the compressed trust tax rates.

### **7.2. Gift Tax**

Regarding the gift tax, an income only trust can be designed so that the transfer is an incomplete gift. No gift tax return would be filed.

### **7.3. Estate Tax**

Since the grantor reserved the right to income, the entire value of the trust would be included in the grantor's estate for federal estate tax purposes.<sup>11</sup>

As previously noted, because the assets are included in the grantor's estate, the estate gets a step up in tax basis as to the fair market value of the assets at the time of the grantor's death. In many cases, this is a significant advantage over outright transfers to children.

## **8. Trust Design**

Care must be taken so that the trust is designed to satisfy the requirements of Medicaid and achieve whatever tax benefits are available.

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<sup>11</sup>I.R.C. §§1014, 2036, 2038; Treas. Reg. §§1.1014-2(a)(3), 1.1014-2(b).

## 8.1. Income

The trust may provide for either mandatory distribution of income to the grantor or discretionary distribution to the grantor. From an income tax standpoint, it is usually preferable to distribute the income to the grantor to avoid income tax at the trust's highly compressed tax rates. However, if the trust is properly drafted as a grantor trust, the income will be taxed to the grantor whether or not distributed.

## 8.2. Principal

Consideration should be given as to when and how distributions of principal can be made.

- *Grantor/Spouse.* There can be absolutely no access to principal by either the grantor or the grantor's spouse. If either the grantor or his or her spouse has access to principal, the assets in the trust will be "available" for Medicaid eligibility purposes.
- *Third Parties.* The trust should be designed to permit the trustee to make distributions to third parties. Through this mechanism, the trustee can stop income payments to a grantor who will be requiring Medicaid and can avoid estate recovery in those states that use a broad definition of "estate." The disadvantage to distributing the assets from the income only trust is that the opportunity for a step up in basis will be lost.

## 8.3. Grantor Trust Considerations

### 8.3.1. Trust Income, Deductions and Credits Attributable to Grantors and Others as Substantial Owners

If the grantor is treated as the owner of a trust, then the income, deductions and credits of the trust are attributable to the grantor.<sup>12</sup>

### 8.3.2. Definitions<sup>13</sup>

#### 8.3.2.1. Adverse Party<sup>14</sup>

An "adverse party" means any person having a substantial beneficial interest in the trust, which would be adversely affected by the exercise or non-exercise of the power

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<sup>12</sup>I.R.C. § 671.

<sup>13</sup>I.R.C. § 672.

<sup>14</sup>I.R.C. § 672(a).

which he possesses respecting the trust. A person having a general power of appointment over trust property shall be deemed to have a beneficial interest in the trust.

**8.3.2.2. Non-adverse Party<sup>15</sup>**

A “non-adverse party” means any person who is not an adverse party.

**8.3.2.3. Related or Subordinate Party<sup>16</sup>**

A “related or subordinate party” means any non-adverse party who is:

- the grantor’s spouse, if living with the grantor;
- the grantor’s father, mother, issue, brother or sister;
- an employee of the grantor;
- a corporation or any employee of a corporation in which the stockholdings

of

the grantor and the trust are significant from the viewpoint of voting control;

executive.

- a subordinate employee of a corporation in which the grantor is an

For purposes of subsection (f) and subsection 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect to the exercise or non-exercise of the powers conferred on him, unless such party is shown not to be subservient by a preponderance of the evidence.

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<sup>15</sup>I.R.C. § 672(b).

<sup>16</sup>I.R.C. § 672(c).

#### **8.3.2.4. Rule Where Power is Subject to Condition Precedent<sup>17</sup>**

A person shall be considered to have a power described in this subpart, even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.

#### **8.3.2.5. Grantor Treated as Holding Any Power of Interest of Grantor's Spouse<sup>18</sup>**

The Grantor shall be treated as holding any power or interest held by any individual who was the spouse of the grantor at the time of the creation of such power or interest, or any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor. An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

### **8.3.3. Reversionary Interests**

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<sup>17</sup>I.R.C. § 672(d).

<sup>18</sup>I.R.C. § 672(e).

Generally, a grantor is treated as the owner of any portion of a trust in which he has a reversionary interest in either corpus or income, if, as of the inception of that portion of the trust, the value of such interest exceeds 5% of the value of such portion.<sup>19</sup> There is an exception of a reversionary interest taking effect at death of a minor lineal descendant beneficiary.<sup>20</sup> Any value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion in favor of the grantor.<sup>21</sup> Any postponement of the date specified in the reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effective.<sup>22</sup>

#### **8.3.4. Power to Control Beneficial Enjoyment**

As a general rule, the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or of the income therefrom is subject to the power of disposition, exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party. The exceptions to the general rule are as follows:

- to apply income in support of a dependent;<sup>23</sup> or
- to appoint after the occurrence of any event such that the grantor would not be treated as the owner under Section 673, if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished; or<sup>24</sup>
- exercisable only by Will, other than a power in the grantor to appoint by Will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a non-adverse party, or both, without the approval or consent of any adverse party;<sup>25</sup>

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<sup>19</sup>I.R.C. § 673(a).

<sup>20</sup>I.R.C. § 673(b).

<sup>21</sup>I.R.C. § 673(c).

<sup>22</sup>I.R.C. § 673(d).

<sup>23</sup>I.R.C. § 674(b)(1).

<sup>24</sup>I.R.C. § 674(b)(2).

<sup>25</sup>I.R.C. § 674(b)(3).

- to allocate among charitable beneficiaries as to corpus or income, if the corpus or income is irrevocably payable;<sup>26</sup>
- to distribute corpus to or for a beneficiary or beneficiaries or to a class of beneficiaries (whether or not income beneficiaries), provided that the power is limited by reasonably definite standard, which is set forth in the instrument; or to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of the income to the beneficiary as if the corpus constituted a separate trust.<sup>27</sup>

The exceptions to the general rule are as follows:

- to withhold income temporary;

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<sup>26</sup>I.R.C. § 674(b)(4).

<sup>27</sup>I.R.C. § 674(b)(5).

- a power to distribute or apply income or to accumulate income provided that any accumulated income must ultimately be payable to the beneficiary or his estate if the beneficiary possesses a power of appointment which is not excluded from the class of possible appointees (any person, other than the beneficiary, his estate, his creditors, the creditors of the estate) or upon termination of the trust to the current income beneficiaries and shares which have been irrevocably specified in the trust instrument.<sup>28</sup>
- to withhold income during disability of a beneficiary.<sup>29</sup>
- to allocate between corpus and income.<sup>30</sup>

### **8.3.5. Exception for Certain Powers of Independent Trustees**

There is also an exception for certain powers of independent trustees.<sup>31</sup>

There is an exception for the power to allocate income if limited by a standard.<sup>32</sup>

### **8.3.6. Administrative Powers**

The grantor shall be treated as owner of any portion of a trust in respect of which the grantor has:

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<sup>28</sup>I.R.C. § 674(b)(6).

<sup>29</sup>I.R.C. § 674(b)(7).

<sup>30</sup>I.R.C. § 674(b)(8).

<sup>31</sup>I.R.C. § 674(c).

<sup>32</sup>I.R.C. § 674(d).

- a power to deal for less than adequate and full consideration,<sup>33</sup>
- a power to borrow without adequate interest or security,<sup>34</sup>
- a power to borrow trust funds,<sup>35</sup> or
- general powers of administration exercisable in a non-fiduciary capacity. These powers include the right to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control.
- a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or

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<sup>33</sup>I.R.C. § 675(1).

<sup>34</sup>I.R.C. § 675(2).

<sup>35</sup>I.R.C. § 675(3).

- a power to reacquire the trust corpus by substituting other property of an equivalent value.<sup>36</sup>

### **8.3.7. Power to Revoke**

Generally, the grantor will be treated as the owner of any portion of a trust where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.<sup>37</sup> Grantor shall not be treated as owner if he has a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under Section 673 if the power were reversionary interest. But the grantor may be treated as the owner after the occurrence of such event unless the power is relinquished.<sup>38</sup>

### **8.3.8. Income for Benefit of Grantor**

As a general rule, the grantor will be treated as the owner of any portion of a trust whether or not he is treated as owner under Section 674, whose income, without the approval or consent of any adverse party is, or, in the discretion of the grantor or a non-adverse party or both may be:

- distributed to the grantor or the grantor's spouse;
- held or accumulated for future distribution to the grantor or the grantor's spouse; or
- applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in Section 170(c) (relating to definition of charitable contributions)).<sup>39</sup>

### **8.3.9. Obligations of Support**

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<sup>36</sup>I.R.C. § 675(4).

<sup>37</sup>I.R.C. § 676(a).

<sup>38</sup>I.R.C. § 676(b).

<sup>39</sup>I.R.C. § 677(a).

Income of a trust shall not be considered taxable to the grantor merely because such income in the discretion of another person, the trustee or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support, except to the extent that such income is so applied or distributed.

### 8.3.10. Person Other than Grantor Treated as Substantial Owner

As a general rule, a person other than a grantor shall be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or such person is previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of Sections 671 to 677 inclusive, subject the grantor of a trust to treatment as the owner thereof.<sup>40</sup>

**Practice Tip:** In using a grantor trust for Medicaid planning purposes, if a child or other beneficiary, serving as trustee, has a right to make a distribution to himself or herself, the benefits of the grantor trust will be lost. The solution is to appoint a trust advisor whose consent is required to make a distribution.

- *Exceptions.* The general rule does not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom Section 679 applies), it is otherwise treated as the owner under the provisions of this sub-part other than this Section.<sup>41</sup>
- *Obligation of Support.* There is an exception to the general rule for a power enabling a person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person in whom the holder of the power is obligated to support or maintain, except to the extent that such income is applied.<sup>42</sup>

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<sup>40</sup>I.R.C. § 678(a).

<sup>41</sup>I.R.C. § 678(b).

<sup>42</sup>I.R.C. § 678(c).

- *Disclaimer.* The general rule does not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.<sup>43</sup>

## 9. Conclusion

A properly drafted income only trust is a marvelous planning technique that is easier for clients to accept than transfers to children. Such a trust gives the parents the feeling that the assets still belong to them, rather than to the children. These trusts can be used to reduce risk for the parents and to achieve tax benefits in appropriate situations. Pitfalls include potential tax disadvantages in an improperly drafted trust, as well as potential estate recovery and elective share issues. By careful analysis of the facts and proper drafting of an income only trust, the elder law practitioner will ensure that the client can truly have his cake and eat it too.

<b>Comparison Between Trusts and Transfers</b>		
<u>Issue</u>	<u>Trusts</u>	<u>Transfers</u>
Lookback	Five Years	Five Years
Control	Some	None
Risk Avoidance	Yes	No
Financial Aid	Yes	No
Estate Recovery	Maybe	No
Income Tax	Parent	Children
Gift Tax	Maybe	Yes
Step Up in Basis	Yes	No
Principal Residence Exclusion	Yes	No

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<sup>43</sup>I.R.C. § 678(d).