What are the tax implications of setting up an irrevocable Asset Protection Trust?

In the best interest of their clients, Accountants are often times concerned about the tax implications of setting up an irrevocable Asset Protection Trust. What assets are being transferred to the Trust? Will the client receive the income from the Trust? Who will pay the tax on that income? Does the client understand a separate tax return will need to be filed?

CONSIDER THE PLAYERS:

The goal in creating and funding an irrevocable Asset Protection Trust is to protect the assets it owns from the devastating costs of long term care. In other words, it's a nest egg that can be strategically used when long term care is needed. Then, at death, it provides a legacy by distributing the remaining assets to or for the benefit of the Trust beneficiaries.

Abiding by the terms of the Trust, however, is critical to ensuring its overall effectiveness. Let's start by taking a look at the players:

Grantor: This is the creator of the Trust and is typically the senior whose assets we are trying to protect. In some cases, it's the senior's Agent under a Power of Attorney who creates the Trust on his or her behalf.

Trustee: This is the manager of the Trust. Because the Trust is irrevocable, the Trustee cannot be the Grantor. However, the Grantor can choose the Trustee, which is typically a trusted friend or family member, or a professional.

Lifetime Beneficiaries: These are people designated by the Grantor who are entitled to withdrawal income or principal from the Trust during the Grantor's lifetime. In some cases, the Grantor chooses to retain the right to receive income from the Trust, but never principal! It is critical to choose the lifetime beneficiaries wisely.

Death Beneficiaries: Upon the death of the Grantor, the assets remaining in the Trust will be distributed to or for the benefit of these individuals and/or charities. Again, the Grantor designates these beneficiaries at the time the Trust is created.

Asset Protection Trusts are created in 2 scenarios: The first is when the senior has 5 foreseeable years before long term care will be needed. The second is when care is needed now and gifting is being recommended in order to qualify for public benefits, like Medicaid and Veterans benefits. Gifting to a Trust is much more secure than outright transfers.

So what type of assets are transferred to an Asset Protection Trust and how is it taxed?

Really any assets, besides tax-qualified retirement accounts, can be transferred to an Asset Protection Trust. However, if the assets produce income, then the Trust terms must be reviewed to determine who are the lifetime beneficiaries of that income <u>and</u> then who pays the income taxes. *They're <u>not</u> always the same!*

Not all Asset Protection Trusts are the same. Understanding who's entitled to the income and how it's taxed is essential.

So, who is taxed on the income?

A <u>Medicaid</u> Asset Protection Trust is always a "grantor trust" for tax purposes, which means that the Grantor is taxed on the income *regardless* of whether the Grantor is entitled to receive the income as the lifetime beneficiary or not. Similarly, if the income stays in the Trust, the Grantor is still taxed on that income. The inclusion of special provisions in the Trust preserve this type of "grantor trust" status.

Regardless of who pays the income taxes, careful review of the Trust is required to see who distributions of income and principal can be made to during the Grantor's lifetime.

On the other hand, if income-producing assets are transferred to a <u>Veterans</u> Asset Protection Trust, then the lifetime beneficiaries (which never includes the Grantor) always receive the income <u>and</u> pay the taxes on that income. This is true even if the Trust retains the income for any reason. The only exception is related to capital gains from the sale of the primary residence.

Procino-Wells & Woodland's Goals

1. Our clients receive the care that they currently need, rather than delaying care for financial reasons.
2. Our clients shelter the maximum amount of their savings.
3. The professionals in our clients' network are included in planning; i.e. facilities and home care agencies receive payment, tax consequences are considered and financial advice is calculated into the plan.

What type of Asset Protection Trust do my clients have?

Determining whether your clients have a Medicaid or Veterans Asset Protection Trust isn't always easy. If you're unsure who's entitled to receive the income and who should pay the tax on that income, then please contact us!

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