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MEDI-CAL & ESTATE PLANNING STRATEGIES
WITH THE PERSONAL RESIDENCE

What is Medi-Cal?

Medi-Cal is a needs based program which provides various health benefits to those individuals with extremely limited assets. The program is funded by both the State of California and the Federal Government. Although there are two types of Medi-Cal, this paper will focus on the long term care Medi-Cal.

Medicare is not an entitlement program. Anyone who qualifies for social security benefits will generally qualify for Medicare. Medicare does indeed cover medical costs, but it only covers up to 100 days of skilled nursing home care. Medicare pays in full for the first 20 days and thereafter, there is a co-payment. After the 100-day period, either the patient pays for the care or Medi-Cal picks up the cost. With the average cost of long term care approximating \$4,000 per month, an estate could be depleted quite quickly, and thus proper planning is extremely important. In fact, it may be malpractice not to bring up Medi-Cal planning during an estate consultation with an elderly couple of modest means.

Medi-Cal planning involves a detailed analysis of the person or couple's assets and determining what assets are "Exempt" property by Medi-cal from those assets that are not exempt. A Medi-Cal recipient can hold assets, even non-exempt assets and still qualify for Medi-Cal. The rules are as follows:

I. Exempt Assets

- A. "Non-exempt" assets for single persons – The resource limit is \$2,000.
- B. "Non-exempt" assets for married persons both on Medi-Cal – The resource limit is \$3,000.
- C. "Non-exempt" assets for married person, where only one is on Medi-Cal – The non-institutionalized spouse can keep at least \$89,280.00 of "non-exempt" assets. This is referred to as the Community Spouse Resource Allowance ("CSRA"). The CSRA may be increased by court order, or

through an administrative hearing, if additional income is needed to meet the Minimum Monthly Maintenance Needs Allowance (“MMMNA”).

- D. Note that after-acquired assets are o.k. for the well-spouse. In other words, subsequent additions to the property of the well-spouse are fine after the date of the Medi-Cal application and will not affect the Medi-Cal eligibility for the institutionalized spouse.

II. Exempt Assets.

- A. Property used as principal residence. When the institutionalized spouse applies for Medi-Cal, he or she must have a subjective intent to return home. It is imperative that the applicant check the box that he or she intends to return home.
- B. Other real property may also be exempt if it is used primarily for self support, such as for work or is necessary for rent income for farmland for food. In addition, even though other property may be non-exempt, valuation is based on the assessor’s property tax roles or appraised value, whichever is lower.
- C. Household furniture, furnishings and appliances.
- D. All musical instruments.
- E. One automobile.
- F. Personal effects and heirlooms, wedding rings and jewelry of any value.
- G. Qualified pension funds in the name of the well spouse.
- H. Qualified pension funds in the name of the “institutionalized spouse providing he or she is receiving payments.
- I. Burial insurance and irrevocable prepaid burial contracts as well as plots; burial fund up to \$1,500.00.
- J. Purchase of an Irrevocable Annuity if applicant receives periodic payments of principal and interest, scheduled to exhaust balance of annuity at or before an of annuitant’s life expectancy.

III. Income Limits.

- A. The “well” spouse is allowed to retain an MMMNA of \$2,232.00 per month. This figure is adjusted annually for inflation. It may be increased by a court order as a result of exceptional circumstances resulting in significant financial distress. The “well” spouse may even keep some of the institutionalized spouse’s income, if necessary, to bring his or her income level up to the MMMNA.
- B. The Institutionalized spouse may keep up to \$35.00 per month. Anything in excess will go to the “well” spouse to bring his or her MMMNA up to \$2,232.00 and the remainder would go to the “institutionalized” spouse’s care.
- C. Look to the name on the instrument to determine ownership for married person.

IV. Planning for Eligibility.

A. The four basic strategies for Medi-Cal planning are:

1. Convert Non-Exempt to Exempt
 - a. Buy a home.
 - b. Make improvements on the home.
 - c. Pay down on the mortgage.
 - d. Buy a new car or trade in.
 - e. Buy new furniture and furnishings – Antiques?
2. Expand CSRA.
3. Transfers of property to “well” spouse.
4. Spend Down.

In utilizing any one of these Medi-Cal planning strategies, tax consequences will come into play. This paper will focus on tax and Medi-Cal strategies for dealing with the family home.

The Family Home

Perhaps one of the most important assets in an estate is the family home. Under both California and Federal law, the transference of a residence does not result in any period of ineligibility. As long as the residence is considered exempt, it doesn't matter whether the Medi-Cal beneficiary retains ownership of the asset. In general under most states Medi-Cal type programs, the residence will only be exempt if the Medi-Cal beneficiary has a subjective intent to return to the residence or it is transferred to a spouse, a disabled child or a sibling who had an equity interest in the home, or who was residing in the home at least one year prior to the institutionalization. In addition, if a child of the beneficiary had been residing in the home for at least two years prior to the institutionalization, and was providing care for the beneficiary, the house would be exempt. On the other hand, in California a gift of the home does not invoke any period of ineligibility. The Department of Health Services (“DHS”) has issued a letter which only requires an affidavit or sworn declaration by the donee to make the transfer exempt.

Outright Gift. The obvious and easiest transaction to recommend is that the client makes an outright gift of the residence to his or her or their family members. Assuming that the person indicates that he or she has the right to return home, the house will not be subject to Medi-Cal recovery claims. However, the beneficiaries/donees will receive no step-up in basis; the gain on any sale of the house will not come within the ambit of Section 121 and if the beneficiaries/donees decide to sell the house the donors could be required to move. In addition, the house would be an asset of the donees and as such, subject to the donees' creditors.

Grant Deed Reserving a Life Estate. This appears to resolve a number of problems, including the step-up in basis and the tax issues under IRC Section 121, but leaves open the question as to whether DHS might withdraw its letter ruling and start recovery actions against life estates. In view of the dwindling government resources, this certainly is a possibility in the future, and accordingly, it is not recommended.

Grant Deed with Right of Occupancy Agreement. A number of practitioners in practice have had the donor deed the real estate outright retaining a right of occupancy agreement. It is clear that IRC Section 121 does not apply upon the sale of the residence since the donor no longer owns the home. However, issues have arisen as to whether there is a step-up in basis upon the donor's death. The answer might depend in part as to whether the donor continues to live in the property, and if not, upon what the donees actually do with the property itself.

Gifts by Non-Institutionalized Donor. Section 1014 affords a step-up basis when property is acquired from a decedent. This section contains two requirements: First, the property must be acquired from a decedent by reason of death, form of ownership or other conditions,; and second, by reason of acquiring the property, the property must be included in the decedent's gross estate.

Assume that parent gave the house to the child, but continued to live there until his or her death. Is there a step-up in basis? The first issue that must be addressed is whether the children acquired the property by reason of death, etc. Treas. Reg. Section 1.1014(b) (2) indicates that prior to death transfers are drawn within the scope of section 1014. In Erma Schrader v. Comm'r (1970), the parents conveyed their personal residence to their daughter, retaining a joint life interest in the property. When the last surviving parent died, the daughter increased her basis under Section 1014(b) (9). The IRS first asserted that Section 1015 applied (carryover basis) and then conceded that a step-up basis under Section 1014 was proper because the parents had retained a life interests in the previously gifted property. In the Medi-Cal situation where the parent continues to live in the property, it appears that such transfers can meet the "acquired from decedent" requirement of Section 1014(b) (9).

The second requirement under this section is to insure that the home will be included in the parents' estates. There have been a number of Revenue Rulings and court cases where gifts of the personal residence were made to the children by the parents and the residence was in fact included in the parent's estate regardless of any enforceable agreement to allow the parents to so reside. See Rev. Rul. 70-155, 1970-1 CB 189; Rev. Rul. 78-

409, 1978-2CB, 234; Estate of Linderme, 52 TC 305; Estate of R. Kerdolff 57 TC 66 (1972) and Estate of Roemer, 46 TCM 1970.

In summary, it appears that there are no insurmountable problems in obtaining the benefit of Medi-Cal planning and step-up in basis in this scenario. In order to achieve this, the clients should transfer their residence and simultaneously enter into a written agreement giving them the right to occupy the residence. Even if there were no documentation, under the Revenue Rulings and case law, there would be a strong case to assert a step-up in basis, providing that the parent(s) continued to live in the residence until their death.

Gifts by Institutionalized Donors. To maintain the exempt status of the personal residence, an institutionalized donor must express an intent to return home, and the donee must supply the DHS with an affidavit that the parent may return home at any time (All County Letter 90-01 Q&A: 8).

At first glance, it appears that Section 2036 should be applicable since the donor has the right to use the property. However, with the exception of the Linderme case, the donor always continued to occupy the residence. In Linderme, the tax court included the value of the donor's residence in his gross estate, notwithstanding the decedent had vacated the residence almost two years prior to his death. The court found that even though Linderme had relocated to a nursing home and did not occupy the residence, actual occupancy did not end prior to his death. The court's reasoning was that the son made no attempt to rent or sell it or even move into the house. Accordingly, the facts indicated that the house was held vacant for the father and thus, he had retained a right of occupancy even though there was no actual occupancy at the time of his death.

With the foregoing in mind, perhaps the most conservative recommendation would be to first obtain a statement of the donor's intent and then to transfer the residence. Contemporaneously with the signing of the deed, there should be some memorialization that the donor can return and use the residence as long as he or she desires. The donee should then be advised to come within the parameters of Linderme and neither lease the residence nor move in it. If the donee takes these steps, it is clear that Section 2036 applies.

On the other hand, with the value and cost of housing, the donee may prefer to either move into the residence or lease it. If so, the donee is moving into un-chartered territory and may run afoul of Section 2036, since these facts are outside the Linderme case. Certainly one way around this as suggested by a number of practitioners is to draft a written agreement which entitles the donor to occupy the residence, making it

very clear of the donor's occupancy rights. Although this may solve the Section 2036 problem, it may also pave way for a challenge by the DHS on the basis that the donor has retained express contract rights to possess and enjoy the property that allegedly had been given away.

Notwithstanding the foregoing analysis, there is at least one additional method to achieve both results. Section 2036 provides that property will be included in a decedent's estate if he retains the right to determine who would enjoy the benefits of the property. With respect to the institutionalized spouse, an irrevocable trust could be set up with the children as beneficiaries. Although the trust would have a trustee, other than the parent, the parent could have a power in the trust to direct which children received income, if any, from the property, assuming that the property was going to be leased out. It could also allow the parent to determine which child or children have the right to live in the house and for what period. These powers alone should be sufficient to bring Section 2036 into play without any contention by DHS as to the donor maintaining a life estate in the property.

Grant Deed With Reserved Powers. Under this scenario, the donor would deed over the property to his or her family members but retain certain powers that would allow the client to retain control without the issue of retaining a life estate. The client could retain a testamentary power of appointment to appoint the property to anyone other than the creditors of the donor and the donor's estate and creditors of the donor's estate. Although this would achieve a step-up in basis under the estate tax laws, a sale would be fully taxed as IRC Section 121 would not apply since the donor no longer owns the house. To minimize the donees ability to sell the residence, an occupancy agreement should also be drawn up.

Intentionally Defective Irrevocable Trust (“IDIT”)- The Pot Sitting Over the Rainbow

There have been a few practitioners who have suggested utilizing an IDIT as a Medi-Cal planning device and in fact are suggesting this in lieu of a living trust. This type of trust is treated as a grantor trust for income tax purposes (and therefore ignored as a separate taxable entity from the grantor), yet respected as a separate entity for gift and estate tax purposes for purposes of determining whether there has been a completed transfer from the grantor to the trust beneficiaries.

As an example, assume Mrs. Forgotten, a widow, has a surviving child, who she loves dearly, but is a spendthrift. Mrs. Forgotten is 85 years old, has a few medical problems, a house fully paid for that is worth \$500,000, and social security of \$1600 per month. She doesn't have long-term care insurance and is very concerned about the costs of a nursing home destroying her estate. You have spoken with her about the disadvantages of Medi-Cal versus a private nursing home, should the event ever arise, and she has made it clear to you that she wants to save the home at all costs. She doesn't want to give the house to her daughter now, as she doesn't trust her daughter's husband, who has filed bankruptcy on no less than two occasions.

Mrs. Forgotten should be advised to set up an intentionally defective irrevocable trust (“IDIT”) that is not only defective for income tax purposes, but also defective for estate and gift tax purposes. In addition, because the trust is irrevocable, there may be asset protection benefits.

There is no magic in making the trust defective for income tax purposes. The instrument must contain one of the powers to give the grantor control, such as (a) the power to borrow funds without adequate security; (b) the power to receive trust income; or (c) the power to reacquire the trust corpus by substituting other property of equivalent value. Any one of these powers will invoke grantor trust status.

To make the trust defective for estate or gift tax purposes, the client could be given a non-assignable testamentary power of appointment to appoint the property to anyone but the creditors of the donor, the donor's estate or creditors of the donor's estate. In addition, the donor should retain some type of beneficial interest in the trust, such as the right to occupy the house or to receive trust income if the house were sold.

Other articles have suggested giving the donor all the right to the income from the trust during the donor's lifetime, along with the right to live in the residence. In the event Medi-Cal ever changes the rules on life-estates, the trust could be subject to

recovery. Accordingly, the donor should not have the right to all the rental income should the house be rented out, if the donor decides not to live there.

If a life estate is created, then there should be no change in ownership problems. On the other hand, if the children are the primary beneficiaries, then the family should apply for a Proposition 58 exemption.

Due to changes in federal law and subsequent 1993 changes in state law, California has adopted the "expanded" definition of estate. In addition to property and assets under the probate definition, California will also seek to recover from "any other real or personal property or other assets in which the individual had any legal title or interest at the time of death, to the extent of such interest." This includes assets conveyed to a survivor, heir or assign of the deceased through joint tenancy, tenancy in common, life estate, living trust or other arrangement.

However, at this point it should be noted that California's Recovery Unit's policy is to recover from revocable life estates, but not irrevocable life estates. But be advised that there are no regulations or formal policy memos regarding life estates, and the use of life estates can be risky. Accordingly, because the IDIT could easily be construed as an irrevocable life estate if drafted improperly, attorneys should be extremely cautious when drafting the instrument to insure that no life estate is created.