

**THE WESTCHESTER COUNTY BAR ASSOCIATION**  
**Elder Law Committee**

**Using EPTL § 7-1.9 to Revoke an Irrevocable  
Trust - Tax and Medicaid Considerations**

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## **Introduction**

While conventional wisdom implies that an irrevocable trust is irrevocable, a New York trust is not irrevocable in the purist definition of the term.<sup>1</sup> In particular, New York Estates Powers and Trusts Law (“EPTL”) § 7-1.9 explicitly provides a mechanism for the creator of an irrevocable trust to revoke such trust upon the written consent of all persons beneficially interested in the trust.<sup>2</sup>

It is important to note, however, that prior to utilizing this mechanism under the EPTL, the elder law attorney must be mindful of the tax and Medicaid implications that will be triggered upon revocation of the irrevocable trust. This paper will explore the relevant tax and Medicaid issues for the elder law attorney to consider when contemplating the revocation of the income only trust pursuant to EPTL § 7-1.9.

## **The Basic Elder Law Trust**

In the context of Medicaid planning, a common irrevocable trust is the income only trust (“IIOT”).<sup>3</sup> In elementary terms, the IIOT is a vehicle where the Settlor transfers her interest in property (i.e., the principal residence or a sum of money) to the trust for the benefit of beneficiaries. To protect the property from being considered available to Medicaid, the terms of the IIOT, in a basic drafting, provide that the Settlor shall receive all income generated by the trust with no ability to access or to be paid the trust principal.<sup>4</sup> The distribution of trust principal is discretionary upon the trustee to the beneficiaries of the trust principal (not including the Settlor).

The creator of the IIOT will be required to pay a gift tax upon transferring property to the IIOT<sup>5</sup> since the Settlor has completed the gift by parting with dominion and control over the property.<sup>6</sup> In certain circumstances, however, an elder law attorney

may attempt to make the transfer of property into the IIOT an incomplete gift which would not subject the transfer to a current gift tax.<sup>7</sup> When drafting the IIOT, this may be accomplished by reserving a “special power of appointment” in the Settlor to appoint trust principal to a class of beneficiaries other than the Settlor, her estate, or the creditors of her estate. The reservation of a special power of appointment will not cause the corpus of the IIOT to be an available resource to the Medicaid applicant/recipient (“A/R”).<sup>8</sup>

### **Tax & Medicaid Implications of Revoking an IIOT**

Before an IIOT is revoked under EPTL § 7-1.9, the elder law attorney must make an appropriate analysis of the estate, gift and income tax ramifications that will result from such an event.<sup>9</sup> In order to determine the tax implications of revoking an IIOT through EPTL § 7-1.9, each trust and plan of distribution must be reviewed on a case by case basis.<sup>10</sup>

***Example 1: A transfers property into an irrevocable income only trust (“IIOT”) governed by New York law. A is entitled to receive all income from the trust for life, but is not entitled to any payments of principal. At A’s death the Trustee must distribute the principal to A’s children, B and C. The trust contains no powers of appointment. With written consent of B and C, A seeks to revoke the IIOT and distribute the respective actuarial interest in the corpus to A, B and C in accordance with I.R.C. § 7520 and applicable regulations. What are the tax and Medicaid consequences resulting from revocation of the IIOT?***

#### A. Gift Tax

This is the precise question answered by the Internal Revenue Service in a 1997 private letter ruling where a taxpayer sought to revoke a New York IIOT pursuant to EPTL § 7-1.9.<sup>11</sup> In PLR 9815023, it is clear that upon creation of the trust the transfer of

the property from A to the trust was a completed gift because the taxpayer lost dominion and control over the property transferred into the trust.<sup>12</sup> Given that after the EPTL § 7-1.9 termination the corpus would be distributed pursuant to the actuarial interests under I.R.C. § 7520, the Internal Revenue Service determined that there would be no taxable gift as a result of the trust termination.<sup>13</sup>

B. Estate Tax

Next, the Internal Revenue Service focused on whether any part of the trust corpus was includible in the taxpayer's gross taxable estate under I.R.C. § 2036 or § 2033.<sup>14</sup> In particular, I.R.C. § 2036(a) includes in a decedent's gross taxable estate the value of any property interest in a trust under which the decedent retained a lifetime income interest.<sup>15</sup> I.R.C. § 2033 includes in the decedent's gross taxable estate the value of all property to the extent of the interest therein at the time of death.<sup>16</sup> In PLR 9815023, the Internal Revenue Service determined that the trust corpus would not be part of the decedent's gross taxable estate under I.R.C. § 2036(a) because, by virtue of the trust termination under EPTL § 7-1.9, there was no trust in existence under which the decedent had retained a lifetime income interest. In contrast, however, the Internal Revenue Service determined that any corpus distributed to A after trust termination would be included in the decedent's gross taxable estate under I.R.C. § 2033 to the extent remaining at her death.<sup>17</sup>

C. Medicaid

In the context of Medicaid eligibility, however, the termination of the IIOT pursuant to EPTL § 7-1.9 would have the effect of making the distribution of the actuarial life income interest to A an available resource which will disqualify A from Medicaid if

its value along with A's other resources exceeds \$4,000.<sup>18</sup> In addition, since the Office of Medicaid Management determines whether a transfer is actuarially sound based upon the Health Care Finance Administration ("HCFA") table<sup>19</sup>, and not the I.R.C. § 7520, some county Departments of Social Services may insist that if the actuarial value under I.R.C. § 7520 is lower than the HCFA table, then the difference would be an uncompensated transfer resulting in a period of Medicaid ineligibility.<sup>20</sup> This is an issue that may need to be challenged at a fair hearing or in court.

Since the property transfer into the IIOT was a completed gift for Medicaid purposes (and caused a Medicaid penalty period), the distribution of the corpus to B and C would not cause any additional eligibility penalty.

***Example 2: A transfers property into an irrevocable income only trust ("IIOT") governed by New York law. A is entitled to receive all income from the trust for life, but is not entitled to any payments of principal. At A's death the Trustee must distribute the principal to A's children, B and C. A reserves a special power of appointment. With written consent of B and C, A seeks to revoke the IIOT and distribute the respective actuarial interest in the corpus to A, B and C in accordance with I.R.C. § 7520 and applicable regulations. What are the tax and Medicaid consequences resulting from revocation of the IIOT?***

A. Gift Tax

In contrast to Example 1, this fact scenario began with an "incomplete" gift by A to the IIOT by virtue of reserving the special power of appointment.<sup>21</sup> The proposed trust termination and distribution to B and C would cause the gift to be complete.<sup>22</sup> Thus,

there can be no doubt that the proposed transfer of the corpus after termination of the trust under EPTL § 7-1.9 will result in a taxable gift transfer by A under I.R.C. § 2511.<sup>23</sup>

B. Estate Tax

As in Example 1, it appears that A's interest in the terminated trust would not be includible in her gross taxable estate under I.R.C. § 2036(a) since the trust interest was terminated.<sup>24</sup> However, to the extent A continues to own any trust property at her death, it will be includible in her gross taxable estate under I.R.C. § 2033.<sup>25</sup>

C. Medicaid

In the past, the Department of Health ("DOH") denied Medicaid benefits to A/R's who were the Settlor of IIOTs that retained a special power of appointment.<sup>26</sup> The basis for the denials was that since the Settlor retained the power to change beneficial interest, the Settlor allegedly could change beneficial ownership to individuals who would consent to revoke the IIOT under EPTL § 7-1.9. In essence, the DOH attempted to assert that no IIOT in which the Settlor retains a special power of appointment is irrevocable due to EPTL § 7-1.9 and should be treated like a revocable trust, an available resource to the A/R.<sup>27</sup> After losing two such challenges in federal and state court, the DOH abandoned this argument and the N.Y.S. Office of Medicaid Management issued a General Information System directing all districts to consider any assets in such a trust unavailable to the A/R.<sup>28</sup>

Unlike federal gift tax law, the trust in Example 2 is a completed gift for Medicaid transfer rule purposes. Thus, the proposed termination and distribution will have the same effect on Medicaid eligibility as in Example 1.

***Example 3: Same facts as Example 2 except A seeks to revoke the IIOT and distribute the respective actuarial interest in the corpus to A. What are the tax and Medicaid consequences resulting from revocation of the IIOT?***

A. Gift Tax

In this example, A did not exercise her special power of appointment; thus, B and C are entitled to their respective actuarial interest in the corpus at termination under EPTL § 7-1.9. However, if B and C agree to transfer their remainder interests at termination to A, then they (and not A) will have caused a taxable transfer of the amount of their respective interests which would cause a gift tax to be assessed against B and C.<sup>29</sup>

B. Estate Tax

Assuming that A possessed any of the value of her life income interest and the corpus at the time of her death, it would be included in her gross taxable estate under I.R.C. § 2033.

C. Medicaid

This example is the extreme case which, assuming that the value of the entire IIOT is greater than \$4,000, would render A ineligible for Medicaid for having excess resources. In effect, A is returned to the asset position she enjoyed before she created the IIOT.

It is important to note, however, that B and C are not eligible for Medicaid until the expiration of the penalty period caused by their gift of the trust corpus to A.<sup>30</sup>

***Example 4: Same facts as Example 2 except A seeks to revoke the IIOT and distribute the entire trust to B and C. What are the tax and Medicaid consequences resulting from revocation of the IIOT?***

A. Gift Tax

As with Example 2, the proposed trust termination and distribution to B and C would cause the gift to be complete.<sup>31</sup> Therefore, there can be no doubt that the proposed transfer of the corpus after termination of the trust under EPTL § 7-1.9 will result in a taxable gift transfer by A of the trust corpus under I.R.C. § 2511.

Most importantly, however, is the fact that, by virtue of transferring the entire trust to B and C, A is relinquishing her life income interest in the trust. This hidden gift tax trap results in a second taxable transfer equal to the actuarial value of A's life income interest.<sup>32</sup> Remember, A not only gifted the trust corpus, but the right to receive the income generated from that corpus for the rest of her life.

B. Estate Tax

The value of A's life income interest under the trust would be part of A's gross taxable estate under I.R.C. § 2035(a) if A died within three (3) years of the termination and distribution of the IIOT.<sup>33</sup> Further, the value of A's gross taxable estate would be increased by the amount of gift tax paid as a result of A's relinquishment of the life estate interest.<sup>34</sup> This is because assets used to pay gift taxes could otherwise avoid being subject to estate tax on the taxpayers death.<sup>35</sup>

C. Medicaid

As in Example 1, the distribution of the corpus to B and C would not cause any additional eligibility penalty to A because the property transfer into the IIOT was a completed gift for Medicaid purposes.<sup>36</sup> However, the transfer of the life income interest by A to B and C will cause an eligibility penalty period for A based upon the HCFA tables.

## Conclusion

From a tunnel vision perspective, EPTL § 7-1.9 may represent a convenient vehicle to correct a planning error, to free certain property from trust, or to accomplish a change in the Settlor's planning wishes. However, a review of the foregoing basic examples underscores the importance for the elder law attorney to consider the web of gift tax, estate tax and Medicaid eligibility implications prior to recommending the utilization of EPTL § 7-1.9 to a client. A decision to revoke an irrevocable trust without entertaining these issues may have a devastating financial impact on a client or may deny the client the ability to continue receiving the care she requires.

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<sup>1</sup> EPTL § 7-1.9 (McKinney's 2005). It important to note that EPTL § 7-1.9 requires that the written consent be acknowledged in the manner required for the recording of a conveyance of real property.

<sup>2</sup> EPTL § 7-1.9(a).

<sup>3</sup> While this paper will focus on the IIOT, it is important to note that the need to assess the tax and Medicaid implications of other common elder law trusts (i.e., Supplemental Needs Trust and Sole Benefit Trusts) must be assessed by the elder law attorney prior to utilizing EPTL § 7-1.9.

<sup>4</sup> 42 U.S.C. § 1396p(d)(3)(B)(i).

<sup>5</sup> I.R.C. § 2511 (BNA 2005); U.S. Treas. Reg. § 25.2511-(2)(b) (BNA 2005).

<sup>6</sup> Of course, however, if the Settlor has not utilized her full federal gift tax applicable exclusion amount of \$1,000,000 then, while a federal gift tax return should be filed, the payment of tax may not be required if there is a sufficient amount of the exclusion available to cover the value of the transferred property.

<sup>7</sup> U.S. Treas. Reg. § 25.2511-(2)(c).

<sup>8</sup> *E.g. Verdow v. Sutkowy*, 209 F.R.D. 309 (NDNY 2002); *Spetz v. New York State Dept. of Health*, 190 Misc.2d 297, 737 N.Y.S.2d 524 (Chautauqua Cty 2002). *See also* GIS 04 MA/001 (1/20/2004).

<sup>9</sup> This paper will not explore the impact on income taxes as a result of a termination under EPTL § 7-1.9 because, by nature, the IIOT is a grantor trust which requires all income to be reported on the Settlor's individual income tax return.

<sup>10</sup> I.R.C. § 2511; U.S. Treas. Reg. § 25.2511-2(b).

<sup>11</sup> PLR 9815023 (December 23, 1997).

<sup>12</sup> I.R.C. § 2511; U.S. Treas. Reg. § 25.2511-2(a); PLR 9815023. Presumably, the taxpayer paid a gift tax upon transfer of the property into the trust since it was a completed gift.

<sup>13</sup> PLR 9815023.

<sup>14</sup> *Id.*

<sup>15</sup> I.R.C. § 2036(a).

<sup>16</sup> I.R.C. § 2033.

<sup>17</sup> PLR 9815023.

<sup>18</sup> 96 ADM-8. GIS 04 MA031.

<sup>19</sup> 96 ADM-8.

<sup>20</sup> *Id.*

<sup>21</sup> U.S. Treas. Reg. § 25.2511-2(c).

<sup>22</sup> U.S. Treas. Reg. § 25.2511-2(b).

<sup>23</sup> Rev. Rul. 67-370; PLR 9802031.

<sup>24</sup> I.R.C. § 2036(a); PLR 9815023.

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<sup>25</sup> I.R.C. § 2033; PLR 9815023.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> I.R.C. § 2511.

<sup>30</sup> 96 ADM-8.

<sup>31</sup> U.S. Treas. Reg. § 25.2511-2(b).

<sup>32</sup> *E.g. Regester v. Commissioner of Internal Revenue*, 83 T.C. 1 (1984). *See also* Rev. Rul. 79-327 1979-2 C.B. 342; TAM 9419007; PLR 8535020.

<sup>33</sup> I.R.C. § 2035(a).

<sup>34</sup> I.R.C. § 2035(b).

<sup>35</sup> Transfers made within three (3) years of death are presumed to be transfers in anticipation of death.

I.R.C. § 2035.

<sup>36</sup> *E.g. Verdow v. Sutkowy*, 209 F.R.D. 309 (NDNY 2002); *Spetz v. New York State Dept. of Health*, 190 Misc.2d 297, 737 N.Y.S.2d 524 (Chautauqua Cty 2002). *See also* GIS 04 MA/001 (1/20/2004).