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Planning With Discretionary Testamentary Trusts (A Useful Tool in the Planner's Box)

By Amy R. Tripp

Many estate planners remain unaware of the proper situation in which a discretionary testamentary trust ("DTT") may provide a desirable option for their clients. This article will attempt to educate planners on this approach, so they can add this useful tool to their box.

Factual Setting Where DTT is Useful

Picture a married couple, typically of advanced age; one spouse is suffering from a condition that could give rise to a need for institutional care such as dementia or a permanent disability. In this situation, the spouse needing care (the "Ill Spouse"), would not be able to remain in the home or non-institutionalized setting with the healthy spouse (the "Caregiver Spouse") providing a significant amount of care and supervision. This situation provides an opportunity for some "out of the box" estate planning options that deviates from the traditional "I love you will" estate planning.

A looming concern in this situation is what would happen if the Caregiver Spouse dies first. Presumably, without the Caregiver Spouse, the Ill Spouse goes into institutional care. At that point Medicaid may or may not become a concern, but the "spend down rules" for Medicaid eligibility, which provide substantial protections to a married person seeking assistance, are much less favorable to a single person. Or, said another way, the assets that the couple owns are more exposed to dissipation on the care costs of the Ill Spouse if the Caregiver Spouse dies first.

The benefit of the DTT is that upon the death of the Caregiver Spouse, some or all of the assets in the estate can be funneled into a protective arrangement, the DTT, where they can remain available for the needs of the surviving Ill Spouse, but where they will not interfere with the ability of the Ill Spouse to become eligible for Medicaid assistance whether in the nursing home or Michigan Choice Waiver benefits. An opportunity to leverage public benefits with other protected resources can provide for more care options for the Ill Spouse.

This does not mean that the Ill Spouse will only be able to receive care in an institutional setting paid by Medicaid. Rather, the resources in the DTT can be used to pay for care in any setting (home, assisted living, etc.), but if Medicaid can benefit the Ill Spouse, the resources in the DTT will be protected. This is because both federal law and Michigan Medicaid regulations dealing with the extent to which assets in trust are considered for Medicaid eligibility purposes provide an exception for "trusts created by will." See 42 USC 1396 p(d)(2)(A) and Bridges Eligibility Manual Item 401, page 5.

The DTT must be discretionary in order to avoid giving the surviving Ill Spouse a legally enforceable property interest in the trust property, which would allow the state to compel distributions and thereby defeat the protective purpose of the Trust. See MCL 700.7505 and also, "The Power of Discretion: An Introduction to Creditor Rights and Disability Planning Under the Michigan Trust Code," D. Chalgian, *Michigan Probate and Estate Planning Journal*, Winter 2009.

Risks

The biggest risk to the client is that the trustee will not use the resources to pay for non-Medicaid alternatives. Because the DTT is discretionary, even though the resources can be used to pay for care in settings where Medicaid may not be available, the trustee can withhold such payments and thereby eliminate more favorable care setting options for the Ill Spouse, leaving Medicaid-covered-institutional care as the only choice. Careful selection of the trustee provides some measure of protection against this result, but no guarantees.

Another risk is that the Ill Spouse dies first. If this occurs, and if the surviving Caregiving Spouse ends up needing institutional care and Medicaid assistance, all of the couple's resources will be exposed to the Caregiver Spouse's care costs. Although predicting which spouse will need long-term care is often a relatively safe bet, that is not always the case; and as every planner knows, crystal ball reading classes are not offered in law school (only at Hogwarts I believe, and then only by invitation).

In discussing this planning approach with clients, it is important that they understand these risks. The option of leaving everything to the surviving spouse remains the best approach if the only objective is the quality of life of the survivor. As we often like to tell our clients, in the world of long-term care: money provides options and the future of government benefits is speculative at best.

It is often a delicate conversation with the Caregiver Spouse when explaining this estate planning option, as they are already overwhelmed and may have trouble with the concept of removing their spouse's name from assets that have been held jointly for forty years or more. There are times that a planner may have the opportunity to counsel the couple when there is an early diagnosis and the Ill Spouse is participating. In those situations, it is sometimes difficult for the Ill Spouse to embrace the idea of giving up ownership and control. However, more often then not, the mentally competent Ill Spouse agrees with the plan and understands that it can provide for more protection of assets and care options in the future.

Other Decisions

If the clients choose this approach, decisions need to be made about (1) who will serve as trustee, (2) where the property will go at the death of the surviving Ill Spouse, and (3) how much is enough?

Depending on the age and health of the Ill Spouse, as well as the size and nature of the estate, it may not always be desirable to fund the DTT with all of the assets of the estate. Ideally, you want enough resources to provide for care for the remainder of the life of the Ill Spouse in the most desirable setting. What that figure is will control how much of the estate is driven into the DTT.

Note also, that it is not wrong (and often a very good idea) to create a DTT arrangement in situations where the Ill Spouse is already receiving Medicaid assistance. The amount that is funded into the DTT in those cases will typically be a smaller amount, as it would commonly be anticipated for use only for uncovered or unanticipated expenses such as nursing home bed holds during temporary periods of hospitalization.

For obvious reasons not covered in this article, funding a DTT with tax-qualified assets should typically be avoided.

When less than all of the estate goes into the DTT, the residue typically goes outright to the other beneficiaries.

The Mechanics of the Plan

Another unique aspect of this planning approach involves the creation of a "pourback trust." The pourback trust exists to facilitate getting the resources into the DTT.

If the DTT is funded with assets that pass through probate, they will be exposed to the rights of the surviving Ill Spouse, which include the various allowances, potentially dower, and, more dramatically, the forced share rights. Failure of a surviving Ill Spouse to exercise these rights may be treated as "divestment" for Medicaid purposes and result in ineligibility. Because of this concern, where possible, these arrangements should be paired with a postnuptial agreement or, even better, a court order terminating spousal rights.

So, rather than funding the DTT with probate assets, the approach should be to create a single revocable trust for the Caregiver Spouse that is funded with the entire martial estate. This revocable trust includes a provision that says if the

Ill Spouse is surviving, some or all of the trust property is to be transferred to the trustee of the DTT (i.e., the "pourback" provision").

For a complete discussion of how to draft these documents, and for forms of these documents and court orders terminating spousal rights, see the ICLE publication, *Michigan Medicaid Planning Handbook*.

At the death of the Caregiver Spouse, if the Ill Spouse is surviving, the will of the Caregiver Spouse would have to be admitted to probate, even though there are presumably no assets in the estate, but simply to validate the DTT and establish the authority of the trustee. Because the DTT is in the will, it does not exist until the will has been admitted to probate.

Conclusion

With an aging population and growing concerns about needs-based government benefits, and Medicaid in particular, the number of situations in which this arrangement may make sense is increasing. In cases where the Caregiver Spouse does in fact predecease the Ill Spouse, and where a suitable trustee is acting, the quality of life of the surviving Ill Spouse is protected, while at the same time there is an ability to preserve the resources for the next generation by accessing Medicaid assistance when such assistance is available and appropriate. This approach is typically preferable to leaving the estate to the children on the death of the first to die and hoping the kids "do the right thing" in terms of using those inherited resources to provide for the needs of their parent.

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