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Revocable Trusts vs. Inheritance Trusts: Medicaid Asset Protection Explained

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Understand the complexities of merging inheritance trusts with revocable trusts for Medicaid spend-down protection. Learn why third-party trusts are treated differently and how to safeguard your assets.

By Harry S. Margolis

Question:

My husband has a trust from his parents. We also have created a revocable trust for our daughter in the hopes of passing our home on to her. Is it possible to fold my husband's trust into our daughter's trust to protect those (modest) assets along with our home from Medicaid spend down?

Response:

Probably not. Medicaid treats trusts created by third parties – your husband's parents in this case – differently from trusts created by oneself or one's spouse – so-called "first-party" or "self-settled" trusts. Trusts created by someone else do not have to be spent down to achieve eligibility for Medicaid as long as there's an independent trustee and the trustee does not have an obligation to make distributions to the beneficiary – in other words, as long as it's a discretionary trust.

The property in self-settled trusts, on the other hand, is considered available to the applicant for Medicaid benefits if the trust is revocable or if it's irrevocable and the trustee has discretion to make distributions to the applicant or their spouse. For Medicaid-planning purposes, some people choose to transfer their assets to irrevocable trusts that do not permit the distribution of principal to themselves or to their spouses. They still may receive income from the trust. That would typically be dividends and interest on investments and rent from real estate.

People are more likely to put their homes rather than other assets in such trusts for two reasons. First, they feel more comfortable tying up their homes in trust as they may need to dip into other assets for living and health care expenses. Second, they're often more attached to their homes and want to preserve them for their children, which seems to be the case for you.

Another reason that your home should not be transferred to the trust your husband's parents left him has to do with taxes. Property in a trust that you and your husband create will receive a step-up in basis when you pass away. This is not the case with property transferred to a third-party trust.

In your case, you may be more free to tie up additional assets in a Medicaid protection trust if the funds in your husband's trust would be available to him and you when and if needed.

Any decision regarding homes and trusts get more complicated when the tax implications and local application of the Medicaid rules are considered. For an answer specific to your state's Medicaid program. I recommend that you consult with a local elder law attorney. One place to find one is at www.elderlawanswers.com.

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Harry S. Margolis practices elder law, estate and special needs planning at Margolis Bloom & D'Agostino in Wellesley, Massachusetts, and is the founder of ElderLawAnswers.com and co-founder of the Academy of Special Needs Planners. He is author of "The Baby Boomers Guide to Trusts: Your All-Purpose Estate Planning Tool" and answers consumer questions about estate planning issues at www.AskHarry.info. Please post your estate planning questions there.