

Reporting the Income of a Medicaid Income Only Trust
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I. Overview of Grantor Trust Rules

Where all or a portion of a trust is deemed to be owned by the grantor of the trust, the grantor will be taxed on the income, deductions, and credits attributable to the portion of the trust deemed owned by the grantor. The grantor trust rules can be found at IRC §§ 671-678.

The following are some of the circumstances that cause the grantor to be treated as the owner of all or a portion of the trust:

- i. where the grantor retains a reversionary interest (IRC § 673);
- ii. where the grantor or non-adverse party has the power to control the beneficial enjoyment of the income or principal of the trust (IRC § 674);
- iii. where the grantor or non-adverse party retains certain administrative powers over the trust (IRC § 675);
- iv. where the grantor or non-adverse party has the power to revoke the trust or appoint the principal to himself (IRC § 676);
- v. where the grantor or non-adverse party has the power to distribute income to the grantor or the grantor's spouse (IRC § 677).

When drafting an IOT, consideration should be given to intentionally creating grantor trust status as to both income and principal.

A typical IOT is generally a grantor trust as to income if the grantor:

- i. retains the right to receive the income of the trust (IRC § 677).

A typical IOT is generally a grantor trust as to income and principal if the grantor:

- i. retains a limited power of appointment to control the beneficial enjoyment of the trust without the consent of an adverse party (IRC § 674); or

- i. has the power to reacquire trust assets by substituting assets of equivalent value (IRC § 675(4)).

Drafting Tip: If an IOT is not a grantor trust as to principal, the grantor will not be able to take advantage of the IRC § 121 exclusion (\$250,000/\$500,000 exclusion for capital gains) if real property is sold that is owned by the trustee of the IOT.

Where there are multiple grantors, each grantor should be treated as grantors for tax purposes. For instance, where a husband and wife each fund a joint IOT, they will each be considered to own half of the trust for grantor trust purposes.

II. Tax Filing Requirements

A. Form 1041

If the trustee of the IOT chooses not to report income under the alternative filing requirements, Form 1041 must be filed for the IOT by the 15th day of the fourth month after year end. An information statement will be generated showing the items of income, deduction and credit that must then be reported on the grantor's individual income tax return. Attached hereto

as an exhibit to my article “Alternative Filing Requirements for a Grantor Trust” (NYSBA Elder Law Attorney, Summer 2008) is a sample Form 1041 for a grantor trust.

When grantor trust status ends, the trust becomes a new separate taxable entity and a new tax identification number should be obtained.

An IOT that continues to exist as a separate entity after the creator’s death will most likely be characterized as a complex trust as opposed to a simple trust.

A complex trust is any trust other than a simple trust.

A trust is a simple trust if:

- (i) the trust instrument requires all income to be distributed currently;
- (ii) the trust instrument must not allow amounts to be paid, set aside, or used in the tax year for charitable purposes; and
- (iii) the trust does not make any distributions of principal (other than principal used to satisfy the required current income) during the year.

B. Alternative Filing Options

In some cases, the trustee of an IOT may avoid the filing of Form 1041 if certain procedures are followed. There are two alternative options that can found at § 1.671-4(b)(2) of the Regulations.

Option One

Under this option, the trustee furnishes the owner's name, social security, number and address of the trust to all payors of income (e.g. banks, etc.). Once this information is processed, the payors of income will issue all Form 1099s to the owners under their individual social security numbers.

Option Two

Once the trustee received each Form 1099 issued to the trust identification number, the trustee can issue 1099s from the trust to the owner.

Query: If the only asset of the IOT is rental real estate, how would you advise the trustee to report the activity of the rental property?