Income Tax Refunds: Another Arrow in the Medicaid Planning Quiver

By Kameron Brooks and Jay William Frantz

An old Chinese proverb states “Crisis is an opportunity riding the dangerous wind.” In the Medicaid world, so many times the winds are indeed dangerous, but every so often the government gives us a break. In 2010, federal law created a safer wind courtesy of section Sec. 728 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.[1] Section 728 provides that federal income tax refunds are not countable as income for “….any Federal program or under any State or local program financed in whole or in part with Federal funds.” By its terms, this section applies to Medicaid. Additionally, refunds are also not countable as a resource for Medicaid qualifying purposes, when received and for a period of 12 months thereafter. And it gets better—if the income tax refunds are gifted or transferred away during the 12 months after received, no penalty period can be assessed for the transfer!

The provisions were to sunset in December, 2012; however, Congress made the winds calm again by making the provisions permanent by the American Taxpayer Relief Act of 2012.[2] In June of this year, the New York Department of Health issued GIS 17 MA/11 to give guidance on the new law to all local Medicaid districts.

Consider how the law interacts with clients. We generally encounter federal income tax withholding in three situations:

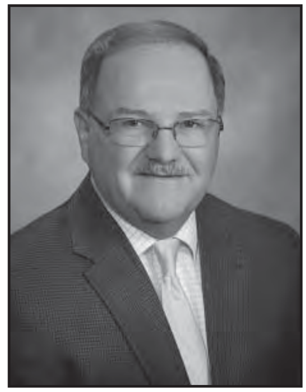
1) employment income where tax is withheld based on the amount we expect to earn and the size of our household;

2) taxes withheld (or paid by estimates) on retirement income (pensions, 401(k)s, IRAs and the like), and

3) tax withheld (or paid by estimates) when liquidating investments.

Situation #1

Consider a client whose husband is diagnosed with Huntington’s Disease. For those who do not know, it is a diagnosis that virtually guarantees the need for long term care, and it is number 11.17 on the list of disabling conditions to qualify for Social Security Disability. To prepare for the inevitable long-term care for the husband, they could begin receiving their federal income tax refunds (assuming, of course, they had over withheld or overpaid by estimates) and within 12 months of receipt, transfer the refunds to a Medicaid Asset Protection Trust and not incur any penalty.



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Situation #1A

Since Huntington’s Disease is a dominantly inherited genetic disorder, one of the husband’s adult working-age children was also tested and diagnosed with the condition. In this situation, the child may consider adjusting his federal income tax withholding upward in order to assist in planning for his inevitable long-term care situation. Increasing the child’s federal income tax refund gives him the opportunity to fund a Medicaid Asset Protection Trust without penalty.

Additionally, in the husband’s and son’s cases, if either, or their spouses, were also receiving Social Security benefits, they could elect to have up to 25 percent of the payments withheld (IRS Form W-4V) for income tax purposes, thus increasing his ultimate refund and penalty-free transfers.

Situation #2

Many of our clients are receiving pension and/or mandatory required distributions from retirement accounts. In many cases these clients are already receiving federal income tax refunds yearly. What if these clients were to receive their refunds and within 12 months (why wait that long?) transfer the refunds to a Medicaid Asset Protection Trust, penalty free? Over a period of years, clients could protect additional funds for their and their families’ future.

Situation #3

A large planning opportunity presents itself when liquidating assets. Consider the client of a financial advisor with whom we recently consulted. She owns a $400,000 annuity and she also is anticipating skilled nursing care soon. If she liquidates her annuity, she can elect to withhold a substantial portion to pay the income tax associated with surrender of the contract. Because her cost basis in the annuity is only $182,000, she will have over $200,000 in taxable ordinary income. Let's presume she withholds 15 percent of the proceeds for a total of $60,000. Not an unreasonable withholding, given her total tax picture. But, if she waits to liquidate the annuity until after she is private paying for skilled nursing home care, she may be have a sizable income tax deduction of $100,000 or more at the end of the calendar year.

Assuming her taxable income consists only of the annuity interest, her total federal tax liability would be $21,947.75 ($200,000.00, less the Schedule A net deduction of $92,500.00, less personal exemption of $4,050.00, times the applicable tax rate). The result would entitle the client to a refund of $38,052.25. When received, the refund is not considered income for Medicaid qualifying purposes, and since it is also not considered a resource for the same purpose, she is free to gift the refund to anyone else, or contribute it to a Medicaid Asset Protection Trust, without incurring any penalty period.

For those who do not have withholding made at the source, how about quarterly estimate payments (IRS form 1040-ES)? Assume a client who has already incurred the taxable income and is anticipating the large Schedule A deduction did not arrange for withholding with the payor. What to do? Consider having the client make an estimated tax payment. The final federal estimate payment is due on January 15th of each year. So, to plan for 2017, the estimate should be paid by January 15th. Can't make it by then? The due dates for estimated payments only relate to the penalty provisions of the Internal Revenue Code. Make a payment late and have a tax liability… pay a penalty for late payment. But if no tax liability, then no penalty. Even if there were a late payment penalty, one can still make an estimated payment. The IRS will always cash the check.

The recent tax bill has since improved situation 3. It made medical expenses greater than 7.5% of adjusted gross income (AGI) deductible for two years. It will go back to the previous, smaller deduction for medical expenses above 10% of AGI after the two year period, however the proposal to remove the deduction entirely was not in the final bill.

What about New York State income tax refunds? The Medicaid Reference Guide (MRG), page 224, states "INCOME TAX REFUNDS—*Any* income tax refund or federal advance payment received by an A/R is disregarded as income in the month received" (emphasis added).[3] Although GIS 17 MA/11 is silent regarding state income tax refunds, GIS 11 MA/004 is not. The last sentence of that GIS states: "State income tax refunds continue to be disregarded as income in the month of receipt and disregarded as a resource the following month." Did the wind just get safer?

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Endnotes

1. 26 USC §6409(a).
2. 26 USC §101(a).
3. The state regulations specifically exempt earned income tax credits and refunds of property and food taxes. 18 NYCRR 360-4.6(a)(1)(xxiii), 360-4.6(a)(2)(ix), and 360-4.6(a)(9). The authors did not find any references to any other tax refunds.