INCOME-ONLY TRUST

The Revival of the Income-Only Trust in Medicaid Planning

Since the enactment of the DRA, an income-only trust is once again a powerful tool in the Medicaid planning toolbox. The principal of such a trust is generally not deemed an available resource for purposes of Medicaid eligibility.

Author: SHIRLEY B. WHITENACK, GARY MAZART, AND REGINA M. SPIELBERG, ATTORNEYS

SHIRLEY B. WHITENACK is a partner in the Tax, Trusts & Estates, and Litigation Departments at the law firm of Schenck, Price, Smith & King, LLP with offices in Morristown and Paramus, New Jersey. She is a Fellow and Director of the National Academy of Elder Law Attorneys ("NAELA"), and a member of its invitation-only Council of Advanced Practitioners ("CAP"). GARY MAZART is Chair of the firm's Tax, Trusts & Estates Department. He is also a Fellow of the American College of Trust and Estate Counsel ("ACTEC") and a member of NAELA. REGINA M. SPIELBERG is a partner in the firm's Tax, Trusts & Estates Department. She is certified as an elder law attorney by the ABA-approved National Elder Law Foundation and a NAELA member.

The federal Deficit Reduction Act[1] ("DRA") drastically changed the rules governing qualification for Medicaid long-term care benefits. While many asset protection planning techniques are no longer viable given the restrictions of the DRA, transfers to income-only trusts have experienced a resurgence as a result of the changes made to the Medicaid transfer of assets rule.

Effect of DRA on Medicaid eligibility

Generally, an individual applying for Medicaid benefits for an institutional level of care program may have no more than $2,000 in countable resources. If the individual is married, the assets of the couple will be pooled together to calculate what portion of the assets the applicant's spouse (the "community spouse") may retain (the "community spouse resource allowance" or "CSRA"). The value of the principal place of residence of the individual or the community spouse, plus one vehicle are not countable resources. The remaining assets owned by the individual or the community spouse must be spent down and/or transferred, if the individual has sufficient assets to pay for care during the applicable "look-back" period.

A penalty period of Medicaid ineligibility is imposed for asset transfers based on the value of the transfer if the transfers were made during the look-back period. The length of the penalty is determined by dividing the fair market value ("FMV") of the transferred asset by the applicable regional nursing home rate.

The DRA tightened the rules governing transfers of assets by (1) extending the look-back period and (2) changing the beginning date of the penalty period. Until 2/8/06, the enactment date of the DRA, the period prior to a Medicaid application during which Medicaid could assess a penalty for making transfers (known as the look-back period) was 36 months for outright transfers and 60 months for transfers to trust. If a transfer was made during the look-back period and the length of the penalty period was greater than 36 months, a penalty period longer than three years would be applied. However, if the application was made 37 months after the transfer, the transfer would be outside the 36-month look-back period and no penalty period would be imposed. If the transfer was to a trust, the 60-month look-back period would apply. The penalty period began with the month in which the transfer was made. The following illustrates the application of the transfer of assets rule as generally applied in all states; the divisor used in this example is the New Jersey statewide divisor.

Example. If a Medicaid applicant transferred $350,000 in January 2006, *before* the enactment date of the DRA, the penalty period would be 50.42 months ($350,000 divided by $6,942 = 50.42). The penalty period would begin on 1/1/06 and end on 2/28/10. However, if the application was made 37 months after the transfer, the transfer would be outside the 36-month look-back period; accordingly, if no other transfers were made, no penalty period would be imposed and the applicant would be eligible on 1/1/09. If the trust rules were applied, the 60-month look-back period would apply and the full 50-month ineligibility period would be imposed.

Example. If a Medicaid applicant transferred $350,000 after 2/7/06, after the enactment of the DRA, the penalty period of ineligibility for this transfer would still be calculated by dividing $350,000 by $6,942 = 50.42. The penalty period would begin at the time the applicant is otherwise eligible for Medicaid services, i.e., *the applicant medically needs an institutional level of care and meets the financial requirements of the Medicaid program.* However, if the application was made more than 60 months after the transfer, the transfer would be outside the 60-month look-back period; accordingly, if no other transfers were made, no penalty period would be imposed and the applicant would be eligible 61 months after the transfer date.

Income-only trusts are popular once again

An income-only trust is an irrevocable trust created by a Medicaid applicant or the applicant's spouse. During the lifetime of the grantor, trust income is typically payable to the grantor or the grantor's spouse. Alternatively, trust income may be payable to other beneficiaries in the trustee's discretion. Trust principal is either retained in the trust or payable to beneficiaries other than the grantor or the grantor's spouse, in the trustee's discretion. At the death of the grantor, the trust may continue with income payable to the grantor's spouse and principal retained or paid to beneficiaries other than the grantor's spouse, or the trust may terminate and the trust assets distributed to or held in further trust for the benefit of the remainder beneficiaries, typically the grantor's children.

The extension of the look-back period for reporting all asset transfers made on or after the DRA enactment date to the 60 months immediately prior to the Medicaid application, combined with the change of beginning date of the penalty period, places income-only trusts on a level playing field with outright transfers to individuals for purposes of the Medicaid penalty period. In other words, clients who make transfers are now subject to waiting 60 months for Medicaid eligibility whether the transfers are to a trust or outright to an individual. Understanding the treatment of trusts in determining Medicaid eligibility is essential to evaluating whether an income-only trust is an appropriate asset protection option in a given situation.

Background

Self-settled irrevocable income-only trusts originally gained popularity in 1985 when the Consolidated Omnibus Budget Reconciliation Act, [2] known as "COBRA 1985," legislated out of existence certain then commonly used discretionary trusts denoting them as "Medicaid Qualifying Trusts." Medicaid Qualifying Trusts were inter vivos trusts established by a Medicaid applicant or the applicant's spouse under which the applicant or the applicant's spouse was the beneficiary of all or part of the payments from the trust as determined in the absolute discretion of the trustees. COBRA 1985 deemed the assets of such irrevocable trusts to be available resources when determining the Medicaid eligibility of the individual or individual's spouse.

Subsequently, the Omnibus Budget Reconciliation Act, [3] known as "OBRA '93," established two distinct look-back periods for reporting any transfers when applying for Medicaid benefits. The look-back period for reporting outright transfers to individuals was the 36 months immediately prior to the date of the Medicaid application, while the look-back period for reporting transfers involving a trust was the 60 months immediately prior to the date of the Medicaid application. [4] The look-back periods are critical because transfers made within the look-back period are subject to a penalty period of Medicaid ineligibility calculated by dividing the FMV of the transferred asset by the regional nursing home rate to obtain the number of months of ineligibility, or penalty period. Under OBRA '93 and prior to the DRA, the penalty period began in the month in which the transfer was made.

Except for special-needs trusts, trusts established with a Medicaid applicant's funds after 8/10/93 by a Medicaid applicant, the applicant's spouse, a court, a person with legal authority to act for the benefit of the applicant, or any other person acting at the direction of the applicant, were not only subject to the longer look-back period but were scrutinized under rigid trust rules. The Medicaid trust rules apply regardless of the purpose for which the trust is established, whether the trustees have discretion over the distributions, if there are any restrictions on whether or when distributions may be made, or on the use of such distributions. [5]

The trust rules, which were unchanged by the DRA, are applied to determine (1) whether any of the trust assets are available to the Medicaid applicant, and (2) whether a transfer of assets has been made. Any portion of the assets of such a trust, whether principal or income, which could be paid to the Medicaid applicant under any circumstances, is considered an available resource to the Medicaid applicant. Actual payments from the trust to or for the benefit of the applicant are considered income of the applicant. Any portion of the assets of such a trust that cannot be paid to the Medicaid applicant under any circumstances, whether principal or income, is deemed to be a transfer of assets as of the date of the establishment of the trust subject to a penalty period of Medicaid ineligibility.

Why use an income-only trust?

The principal of an income-only trust, which by its terms pays only income to the Medicaid applicant and/or the applicant's spouse or to other beneficiaries in the discretion of the trustees and cannot distribute principal to the Medicaid applicant or the applicant's spouse, will not be deemed an available resource for Medicaid eligibility purposes. The principal either remains in the trust until the death of the applicant and/or the applicant's spouse or may be paid to a beneficiary other than the applicant or the applicant's spouse. The funding of an income-only trust is deemed an uncompensated transfer for Medicaid purposes and, if the Medicaid application is filed within the look-back period, will result in a period of ineligibility.

Generally, payments from trust principal to beneficiaries other than the grantor or the grantor's spouse will not be deemed uncompensated transfers according to a 12/23/93 letter from Sally K. Richardson, then director of the Medicaid Bureau of the Department of Health and Human Services, Health Care Financing Administration, which stated that, "where a portion of a trust cannot, under any circumstances, be distributed to or for the benefit of the grantor, that portion is never considered an available resource to the grantor."[6] With regard to income-only trusts, however, it remained unclear for several years following the Richardson letter whether the transfer occurred at the time of the transfer to or from the income-only trust. The matter was clarified by Robert A. Streimer, Director, Disabled and Elderly Health Programs Group, Center for Medicaid and State Operations, Health Care Financing Administration, Department of Health and Human Services, who stated in a letter dated 2/25/98 that the transfer occurred when the assets were transferred to the trust.[7]

Prior to the enactment of the DRA, elder and disability law practitioners had to balance the extended trust look-back period triggered by the implementation of an income-only trust against the shorter look-back period triggered by outright transfers to individuals. In circumstances where the ineligibility period triggered by the transfer to the income-only trust was less than or equal to the then look-back period for outright transfers (36 months), clients typically chose to create an income-only trust. By contrast, in circumstances where the ineligibility period triggered by the transfer to an income-only trust substantially exceeded the 36-month look-back period, clients opted for outright transfers, or other planning devices that would be treated like outright transfers and triggered no more than a 36-month look-back period. After the enactment of the DRA, the analysis changed for all transfers made after 2/7/06.

Aside from the Medicaid availability/transfer analysis, income-only trusts offer a number of well-known tax benefits. Although irrevocable, if the grantor retains ownership or control, an income-only trust can be structured as a "grantor trust." Specifically, this will result if a grantor does one of the following:

> (1) Derives benefits from the income.
> (2) Retains the power to revoke the trust.
> (3) Retains power over beneficial enjoyment.
> (4) Retains power to exercise certain administrative control over the trust's operation, i.e., to purchase assets for less than full consideration or to borrow funds without adequate security.
> (5) Retains a reversionary interest of more than 5% in either principal or income.[8]

If any of these apply, income is treated as "owned by" and taxed back to the grantor. Grantor trust tax treatment allows the income to be taxed at the grantor's individual income tax rate. Individual income tax rates are usually less compressed than trust income tax rates. Further, a grantor/parent is typically in a lower income tax bracket than his or her children, providing a potential income tax savings over an outright transfer to children.

An income-only trust can be structured so that the assets receive a step-up in basis on the death of the grantor, i.e., on the sale of the asset by the trust's remainder beneficiary, the basis is its FMV on the grantor's date of death, which often avoids significant capital gains tax.[9] In contrast, assets transferred outright to donees during lifetime are subject to “carryover” basis rules, i.e., on the sale of the asset by the donee, the basis remains the donor's basis and the donee is responsible for the capital gains tax on all of the appreciation. [10]

The principal residence of elderly clients is often a highly appreciated asset and, as such, the issue of capital gains tax must be considered. For an individual, up to $250,000 of capital gain on a principal residence can be excluded from gross income if the property was owned and used by the taxpayer for two of the five years preceding its sale (or one of five years if the taxpayer becomes incapable of self-care and requires care outside the home) so long as the exclusion has not been claimed by the taxpayer within two years of the date of sale. Taxpayers filing jointly can exclude up to $500,000 even if only one is the property owner so long as both spouses have used the residence for two of the five years preceding its sale and neither has claimed the exclusion within two years of the date of sale. [11]

If the residence is transferred from the parent to the children as part of an asset protection plan, the children will take it with the parent's basis, which often is quite low. When the child later sells the residence, the appreciation will be subject to capital gains tax. An income-only trust can be structured to preserve the capital gains tax exclusion on the sale of the principal residence. Specifically, if an income-only trust is treated as a grantor trust as to its income and principal under Sections 671 through 679, by providing, for example, that the grantor has the right to acquire trust property by substituting property of equal value to the property acquired, the grantor will be treated as the continued owner of the residence for purposes of the capital gains tax exclusion. [12]

Clients who want to plan for future long-term care costs even though they may not presently have serious health issues typically have concerns about the loss of control that accompanies an outright transfer of their assets to their children. An income-only trust can address the concerns of those clients by allowing the client to retain some control over the disposition of assets at death. An income-only trust also provides protection from creditor claims of the trust beneficiaries except to the extent of the grantor's retained interest, whereas an outright transfer of assets to the grantor's children subjects those assets to the children's creditors. In addition, if the grantor's grandchildren are nearing college age, the grantor's child may not want excess assets in his or her own name that might compromise educational financial aid.

Estate recovery

Federal law requires states to institute programs to recover nursing home and long-term care Medicaid expenses paid after 10/1/93, from the estates of deceased Medicaid beneficiaries. [13] Whether the assets of an income-only trust are subject to estate recovery depends on whether the state uses a narrow probate definition of “estate” in their Medicaid recovery program or defines “estate” more broadly to include probate and nonprobate assets. At a minimum, estate recovery must be made against any real and personal property or other assets that are includable in a decedent's estate, as defined under state probate law. The term "estate" can be more broadly defined, at the option of the state, to include "any other real and personal property and any other assets in which the individual had any legal title or interest at the time of death (to the extent of such interest), including such assets conveyed to a survivor, heir, or assign of the deceased individual through joint tenancy, tenancy in common, survivorship, life estate, living trust, or other arrangement." [14]

Recovery may be made only after the death of the Medicaid recipient's spouse and may not be made if there is a surviving child who is a minor or who is disabled or blind. [15] At least 30 states, including New York and Pennsylvania, use the narrow probate definition of estate in their Medicaid recovery program, while at least 14 states, California, Connecticut, and New Jersey among them, use an expanded definition of estate in their Medicaid recovery programs to include both probate and nonprobate assets. [16]

In states, such as Pennsylvania, with a narrow definition of estate recovery (that is, limited to probate assets), an income-only trust should not be subject to estate recovery. In contrast, New Jersey regulations define "estate" under the broader definition but do not include (1) a life estate in which the Medicaid beneficiary held an interest that expired upon his or her death; (2) an inter vivos trust established by a third party for the benefit of the Medicaid beneficiary, provided that the Medicaid beneficiary cannot compel distributions from the trust *and* that the trust contains no assets in which the Medicaid beneficiary held an interest within five years of his or her Medicaid application or his or her death; or (3) a testamentary trust established by a third party, including the spouse of the Medicaid beneficiary, provided that the Medicaid beneficiary cannot compel distributions from the trust *and* that the trust contains no assets in which the Medicaid beneficiary held an interest within five years of his or her Medicaid application or his or her death. [17]

Under the expanded definition of estate, however, an income-only trust established with the assets of a Medicaid recipient for his or her own benefit will be subject to estate recovery. It would seem then that an income-only trust established for the benefit of the spouse of a Medicaid recipient, in which a Medicaid recipient holds no legal interest at the time of his or her death, would not be subject to estate recovery. There are circumstances, though, when some states with expanded definitions of estate recovery will seek to recover amounts paid for medical assistance on behalf of a Medicaid recipient against the estate of the spouse of the Medicaid recipient, even against assets in which the Medicaid recipient holds no legal interest at the time of his or her death.

In *Estate of DeMartino*, the New Jersey Appellate Division concluded that Medicaid was entitled to satisfaction of its lien against property held in a testamentary trust established by a community spouse for the benefit of the Medicaid recipient spouse, where the trust was funded with assets transferred from the Medicaid recipient within five years of applying for Medicaid benefits. [18] In Minnesota, an expanded estate recovery state, Medicaid was entitled to recover against the estate of a Medicaid recipient's spouse for the one-half interest in the joint tenancy real property obtained during the marriage that was transferred by the Medicaid recipient to her community spouse husband, who died six months after her death. [19]

In contrast, some states with expanded estate recovery provide for a narrower interpretation of federal estate recovery rules. A Wisconsin appellate court found that a statute allowing Medicaid to recover medical assistance benefits from the estate of the Medicaid recipient's spouse violated OBRA '93. [20] The court held that Medicaid could not recover from the estate medical assistance benefits paid on behalf of the decedent's predeceased wife because federal law did not authorize such recovery of benefits.

Faced with the possibility of estate recovery from an income-only trust, a trustee may decide to distribute the entire principal of the trust to the permissible non-Medicaid recipient beneficiaries. In the New Jersey matter of *J.S.,* [21] J.S. was the grantor of an income-only trust, the terms of which provided that the income be paid annually to him but gave him no access or control over trust principal. Prior to the grantor's submitting a Medicaid application, the son/trustee terminated the trust and retained the assets.

Medicaid argued that the entire principal of the trust, as well as the income generated, should be counted as available resources. The applicant/grantor argued that since no portion of the trust principal could be used for his benefit from the date it was transferred to the trust, that date should be the starting date for any penalty period of Medicaid ineligibility. The final agency decision found that the transfer of assets took place when the applicant/grantor gave up his right to principal and transferred the assets to the trust. The trust termination created an additional transfer of the income right that triggered a penalty period of Medicaid ineligibility and was valued based on the life expectancy of the applicant/grantor.

Medicaid as a creditor

A creditor is broadly defined as one to whom a debt is owed by another. [22] A lien is a creditor's claim on another's property to pay a debt or obligation. Medicaid liens on the real property of living Medicaid recipients have been permitted in limited circumstances since 1982. [23] States have the option to use liens on the primary residence of a Medicaid beneficiary to prevent pre-death transfers of permanently institutionalized Medicaid recipients. [24] Does the Medicaid right to estate recovery result in Medicaid's treatment as a creditor of the Medicaid beneficiary's estate, including any income-only trust created by the Medicaid beneficiary? If Medicaid is a creditor, is a Medicaid recipient then treated as a debtor?

Federal law is silent on this issue. State probate and property law is controlling. Some states (e.g., Pennsylvania) file liens as part of the probate process. Under the Pennsylvania Medical Assistance Estate Recovery ("MAER") Program, the lien is considered an unsecured lien. In Pennsylvania, Medicaid is a creditor with a claim against the estate. This creditor status does not exist prior to the death of the Medicaid beneficiary. The portion of the MAER claim that relates to Medicaid benefits paid for services rendered during the decedent's last six months of life receives priority over most other estate creditors. [25] New Jersey Medicaid law does not address Medicaid's status as a creditor. In New York, the Appellate Division rejected a claim by Medicaid that the transfer of the marital home to an income-only trust violated debtor/creditor law. [26]

Although not addressed in the *J.S.* decision, the facts of that case raise additional concerns regarding Medicaid's status as a creditor. Specifically, does the trustee of an income-only trust engage in a fraudulent transfer by distributing the trust principal prior to either the grantor's eligibility or submission of a Medicaid application?

The Uniform Fraudulent Transfer Act states that a transfer is fraudulent as to present and future creditors if the debtor made the transfer or incurred the obligation (1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction, or intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they become due. This standard applies whether the creditor's claim arose before or after the transfer was made or the obligation was incurred. [27]

Transfers to trusts for Medicaid planning purposes and distributions from trusts to beneficiaries other than the Medicaid applicant, made without actual or constructive fraudulent intent, will protect the assets from future creditors of the trust beneficiaries. The transferor should not render him or herself insolvent, as this could be construed as evidence of fraudulent intent. Fraudulent transfers will be deemed void and, therefore, the assets will be counted as available resources to the beneficiary, or will be subject to recovery.

Attorneys should also be aware of their own potential personal liability in transfer situations. In *Banco Popular*, [28] an attorney assisted a client in transferring assets to the client's spouse while guaranteeing loans for a business with those assets. The business failed and the client was insolvent. The New Jersey Supreme Court held that where there was a fraudulent transfer and the defendant attorney knew the transfer was fraudulent and agreed to assist in the transfer, the defendants will be jointly liable as a co-conspirator. In *Morganroth,* [29] the Third Circuit held that an attorney may be sued for aiding a fraudulent transfer.

Elective share

An elective share is a right of a surviving spouse, provided by statute, to choose between taking what is provided in the will of the deceased spouse or taking a statutorily prescribed share of the estate, which, in most states, is approximately one-third of the estate. The right may be exercised if the will leaves the spouse less than he or she would otherwise receive by statute, and is intended to prevent the impoverishment of the surviving spouse. The assets of an income-only trust with provisions for distribution to children on the death of the community spouse will be subject to elective share statutes.

The Medicaid agency may require that the Medicaid recipient exercise his or her right to an elective share. Failure to exercise the right to the elective share, in some states, is deemed a transfer of assets subject to a Medicaid penalty period of ineligibility.

For example, if a deceased community spouse leaves an estate of $600,000 and the will omits the surviving spouse, the surviving spouse must exercise his or her right to the elective share, $200,000 in this example. If the surviving spouse fails to do so and applies for Medicaid benefits, Medicaid will consider the failure to elect as a transfer of $200,000 and impose a penalty period of Medicaid ineligibility on the surviving spouse. Such was the holding in *I.G.* [30] where the court found that the agent under a Medicaid recipient's power of attorney had the right to demand the spousal elective share and the failure to do so on behalf of I.G. constituted a transfer for less than FMV, resulting in a penalty period of ineligibility.

One way to avoid the elective share problem is to provide that, on the death of the community spouse, the income-only trust assets pour back into the estate of the community spouse. The community spouse should have in place a will that creates a trust providing for the payment of the trust income to the Medicaid recipient surviving spouse and principal payments in the discretion of the trustee for the supplemental or special needs of the surviving spouse. Some states, including New York and Pennsylvania, require a distribution to a surviving spouse to be made outright or it will not satisfy the elective share. Moreover, in income cap states, if a Medicaid applicant's income (including income from an income-only trust) exceeds the income cap, the applicant will be ineligible for Medicaid.

Conclusion

Since the enactment of the DRA, an income-only trust is once again a powerful tool in the Medicaid planning toolbox when used properly in certain circumstances. Unlike outright gifts, the income-only trust can establish Medicaid eligibility while permitting the grantor more control over the distribution of the assets and protecting the grantor's assets from certain creditors' claims. Additionally, income-only trusts offer federal tax advantages. Care must be taken, however, to ensure that the trust assets are not subject to Medicaid estate recovery, especially in states that have adopted definitions of "estate" that are not limited to probate assets.

PRACTICE NOTES

To minimize potential estate recovery by Medicaid, the community spouse should create an income-only trust, preferably with assets in which the Medicaid recipient has not had a recent ownership interest.

1 Pub. L. No. 109-171 (2/8/06).

2 42 U.S.C. §1396a(k)(2) [now repealed].

3 Pub. L. No. 103-66 (8/10/93).

4 42 U.S.C. §1396p(c)(1)(B)(i).

5 42 U.S.C. §1396p(d).

6 Kruse, *Third-Party and Self-Created Trusts*, p. 229 (Chicago: American Bar Assoc., 2d ed., 1998).

7 Begley and Saunders, *New Jersey Elder & Disability Law Practice,* p. 7-45, edited by Gary Mazart (New Brunswick: New Jersey Institute for Continuing Legal Education, 3d ed., 2006).

8 Section 673-Section 677.

9 Section 1014.

10 Section 1015.

11 Section 121.

12 Reg. 1.121-1(c)(3).

13 42 U.S.C. §1396p(b).

14 42 U.S.C. §1396p(b)(4).

15 42 U.S.C. §1396p(b)(2)(A).

16 See Oppenheim and Moschella, "National Perspective on Expanded Estate Recovery: Case Law Analysis, Emerging Legislative Trends and Responsive Strategies for the Elder Law Attorney," 1 NAELA J. 7 (Spring 2005).

17 N.J.A.C. 10:49-14.1.

18 Estate of DeMartino v. Div. of Med. Assistance and Health Servs., 861 A2d 138 (App. Div., 2004); appeal dismissed by, certif. denied by 866 A2d 982 (2005).

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In re Estate of Barg, 752 NW2d 52 (2008), *rehearing den*., 2008 Minn. LEXIS 409 (7/21/08).
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In re Estate of Budney, 541 NW2d 245 (Wis. Ct. App., 1995), *review den*. 546 N.W.2d 471 (Wis., 1996).
21

J.S. v. Division of Medical Assistance and Health Services, Docket No. HMA-4896-06. Final Agency Decision (3/22/07).
22

Black's Law Dictionary (6th ed. Thomson Reuters/West).
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42 U.S.C. §1396p.
24

U.S. Dept. of Health & Human Servs., *Medicaid Liens* (April 2005), at http://aspe.hhs.gov/daltcp/Reports/liens.htm.
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20 Pa.C.S. §3101.
26

Matter of Tomeck, 872 NE2d 236 (2007).
27

Uniform Fraudulent Transfer Act.
28

Banco Popular North America v. Gandi, 876 A2d 253 (2005).
29

Morganroth & Morganroth v. Norris, McLaughlin & Marcus, 331 F3d 406 (CA-3, 2003).
30

I.G. v. Dept. of Human Servs., 900 A2d 840 (App. Div., 2006).