§ 3.03 Inheritance & Lifetime Gifting

Transfers to third-party SNTs by way of inheritance or lifetime gifting are efficient ways to fund third-party SNTs.

[1] Introduction

A SNT established for the benefit of a person with a disability and funded with assets that do not and never have belonged to the beneficiary are usually referred to as "third-party SNTs." Unlike the first-party, or (d)(4)(A), SNTs discussed in § 3.02, where the source of funding legally belongs to the SNT beneficiary, third-party SNTs are funded with assets that have never belonged to the SNT beneficiary. As such, they are not subject to the payback requirements that govern (d)(4)(A) trusts or (d)(4)(C) trusts (see § 3.02) (if the (d)(4)(C) trust's assets are not committed to charitable purposes) nor are they considered "countable resources" for determining SSI (see § 9.04), Medicaid (see § 9.07), or subsidized housing eligibility. However, distributions from third-party trusts can affect all of these public benefit programs.[1]

[2] Directing Inheritance to Third-Party Trust

Once upon a time, the parents of a child with a disability would leave that child's presumed share of her inheritance to a sibling with the explicit or implicit understanding that the sibling would use the additional inheritance for the benefit of his sibling who has a disability. Once upon a time, in the days of intact, cohesive family units this may have worked. Unfortunately, given the vagaries of human nature, and the laws governing such transfers, this type of planning for the needs of a sibling with a disability frequently didn't work or, at least, did not work as intended. The sibling receiving the additional inheritance was legally free to use the additional assets as he wished and the assets were of course exposed to that child's debts and creditors. In addition, where significant sums were involved, the addition of these inherited assets could quite possibly cause the estate to incur estate tax liability on the death of the recipient sibling, imposing additional burdens on future generations of the family.

This type of estate planning strategy often created strains within the family unit, causing increased sibling rivalry between the "haves" and the "have-nots," frequently exacerbating existing issues among siblings where life-long resentments between the siblings were now manifested in tight control over distributions of funds.

Furthermore, this type of estate planning model was premised on an intact, geographically cohesive family unit. In today's world, it is possible that the sibling with a disability is the only child from the third marriage and the other siblings are the result of former marriages or liaisons. With the parents all living in different parts of the world and rarely seeing each other, the practicality of leaving the share of the child with a disability to a healthy sibling makes less and less sense. Thus, for reasons that go far beyond the need to protect the public benefit eligibility of a child with a

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[1] See §§ 8.03–8.05 (SSI), 10.03–10.07 (Medicaid), 12.06 (Housing) of Regan, Morgan, English, *Tax, Estate & Financial Planning for the Elderly* (Matthew Bender) for more information on eligibility requirements for these programs.

disability, families are finding the use of third-party SNTs more and more attractive.

[a] Parents

The great majority of parents leave their estates in equal shares to their children, whether outright or in trust. In most families this occurs on the death of the surviving parent. When one of the children has a disability, the most efficient way to utilize a third-party SNT is to leave that child's share to a third-party SNT.

When the parents are utilizing a revocable inter vivos trust as their estate planning vehicle, the SNT can be embedded within the family's trust and the share of the estate of the child with a disability simply drops down into the embedded SNT upon the death of the surviving spouse. For sample language for this kind of provision see Form 3.201.[1]

In situations where the parents have not utilized a revocable inter vivos trust as their estate planning vehicle or where it is anticipated that lifetime gifting to the third-party SNT will be taking place, a stand-alone third-party SNT should be utilized. In this case, the dispositive provisions of the parents' estate plan should provide that the share of the child with a disability is to be distributed to the existing trust. The language in Form 3.201 can be modified accordingly. For a discussion of lifetime gifting to existing third-party SNTs, see § 3.03[3].

[b] Grandparents

The same thought processes and techniques that parents go through and utilize in determining how and when to fund a third-party SNT apply to grandparents as well. Grandparents (and their advisors) need to be mindful that gifts to third-party SNTs for the benefit of grandchildren with disabilities may be subject to the Generation Skipping Transfer Tax rules in the same manner as other gifts to grandchildren or other "skip persons" as defined in the Internal Revenue Code.[2]

[c] Siblings and Others

When there is an existing third-party SNT and the trustee of the trust has authority to accept gifts from others (whether or not "Crummey" provisions are included), there is no reason that siblings, other family members or friends of the SNT beneficiary cannot contribute assets to the trust.

[3] Gifting to Third-Party Trust

[a] Annual Exclusion Gifts

Gifts to trusts ordinarily do not qualify for the annual gift tax exclusion because gifts

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[1] For a discussion of estate planning in general see Burke, Friel, Gagliardi, *Modern Estate Planning* (Second Edition Matthew Bender).

[2] I.R.C. § 2601 *et seq.* For a more detailed discussion of the Generation Skipping Transfer Tax rules and regulations see Burke, Friel, Gagliaradi, *Modern Estate Planning* (Second Edition) ch. 18 (Matthew Bender).

to trusts do not constitute the transfer of a present interest.[1] In order for a gift to a trust to qualify for the annual gift tax exclusion the trust must contain what are commonly known as *Crummey* powers. *Crummey* powers, which are more commonly used in connection with irrevocable life insurance trusts, give the trust beneficiary who holds the power the present right to demand all or at least a portion of the gift. This demand right creates a present interest sufficient to satisfy the requirements of the annual gift tax exclusion.

Unfortunately, in the context of SNTs, giving the SNT beneficiary a right to demand a distribution of a contribution to the trust will probably disqualify that beneficiary from receiving SSI or Medicaid since the amount the beneficiary will be able to demand will probably exceed the applicable resource limit (usually $2,000).

On the other hand, if the SNT does not qualify for the annual gift tax exclusion, possible contributors will have little or no incentive for making lifetime contributions to the SNT because gifts made to the SNT that do not qualify for the annual gift tax exclusion become taxable gifts requiring the filing of a gift tax return and reduce the donor's lifetime gift tax exemption (currently $1,000,000) by the amount of the gift, thus potentially adversely affecting the donor's over-all estate planning goals.

The answer to this dilemma is found in the case of *Estate of Maria Cristofani.*[2] In *Cristofani*, the Tax Court held that a beneficiary other than the primary beneficiary of the trust could be a valid *Crummey* power holder so long as the beneficiary had a vested remainder interest in the trust. Thus, in the case of a SNT, the trust would be drafted to provide that the primary beneficiary is the person with a disability and on her death the remaining trust corpus is to be distributed to her siblings, nieces, and nephews (for example), all of whom are identified by name. Each of these remainder beneficiaries would also be named as a *Crummey* power holder, but the primary beneficiary would not. It is not necessary that each of the remainder beneficiaries have an equal share in the remainder, only that their interest not be contingent. For example, the trust could provide that on the death of the primary beneficiary 70% of the remainder is to be distributed to the primary beneficiary's brother, and 10% each to 3 nieces and nephews. This would create a situation where there were four potential *Crummey* beneficiaries without any adverse impact on the primary beneficiary.

[b] Tax Issues

Using *Crummey* powers in SNTs raises the same tax issues as using them in other types of trusts. The power to withdraw contributed assets creates a general power of appointment over those assets.[3] If the right to withdraw is not exercised, the power of appointment lapses and is considered a gift by the *Crummey* power holder to the extent the value of the power of appointment (i.e., the amount that could be withdrawn), exceeds the greater of $5,000 or 5 percent of the value of the assets from which the

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[1] I.R.C. § 2503(b).

[2] 97 T.C. 74 (1991) *acq.*, 1992-1 Cum. Bull. 1, *acq.*, 1996-2 Cum. Bull. 1.

[3] I.R.C. § 2514(c).

power of appointment could have been satisfied.[4] Furthermore, the gift of the amount in excess of the "5 or 5" power resulting from the beneficiary's failure to exercise the *Crummey* powers causes a portion of the trust equal to the proportion of the value of the total trust estate attributable to the gift to be includable in the beneficiary's estate for federal estate tax purposes[5] and may also be considered a completed gift for gift tax purposes.[6]

Since a third-party SNT with *Crummey* provisions may be part of an over-all, multi-generational estate plan, careful consideration should be given to the structuring of the *Crummey* provisions. The drafting attorney should also pay careful attention to the identity of the remainder beneficiaries who will be granted *Crummey* withdrawal rights since an individual donee is only allowed one "5 or 5" amount to lapse each year.[7] Cavalierly naming the primary beneficiary's cousin as a *Crummey* power holder without checking with that person (or his parents) first as to what other "5 or 5" powers he may have could have catastrophic results on the estate plan of the power holder or his parents.

Some of the concerns regarding the lapse of "5 or 5" powers can be avoided or mitigated by using hanging powers. A "hanging power" provides that the power lapses on a date certain (December 31 for example) and then only to the extent of the "5 or 5" amount, leaving the remaining portion to lapse in subsequent years when no *Crummey* gift is made. Using hanging powers or other techniques does not necessarily guard against unwanted lapses which can occur through trust distributions or death.[8] For sample language used to create *Crummey* powers in a third-party SNT, see Form 3.202.

[c] Taxable Gifts

If there is no need or desire to take advantage of the annual gift exclusion in connection with funding a third-party SNT, the grantor or donor can simply gift assets to the SNT. Such gifts, assuming the third-party SNT is irrevocable at the time, constitute taxable gifts and the donor will be required to file a federal gift tax return (and possibly a state gift tax return, depending on the donor's jurisdiction).[9]

The gift will reduce the donor's lifetime gift tax exemption ($1,000,000 in 2009). Until the exemption is totally exhausted the donor does not pay any gift tax.[10] One advantage of this technique is that it enables a donor to transfer an asset's future

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[4] I.R.C. §§ 2041(b)(2), 2514(e).

[5] I.R.C. § 2041(b)(2).

[6] I.R.C. § 2514(b).

[7] Rev. Rul. 85-88, 1985-2 C. B. 201.

[8] For a more detailed discussion of *Crummey* powers, the impact of *Cristofani* and "5 or 5" powers generally, see Burke, Friel, Gagliardi, *Modern Estate Planning* (Second Edition) §§ 8.08, 2.08 (Matthew Bender).

[9] I.R.C. § 6019.

[10] I.R.C. § 2502(a).

appreciation out of her own taxable estate, theoretically reducing the ultimate estate tax liability to the donor. On the other hand, since gifts carry with them the donor's original basis for income tax purposes,[11] the third-party SNT will receive the asset with the donor's basis rather than the stepped-up basis it would receive if the property were a testamentary gift.[12] The effect of this difference in basis likely results in higher income taxes to the trust at the time the asset is sold because the gain will be calculated based on the donor's original basis rather than the (presumably) higher stepped-up basis.

Since taxation issues permeate SNT contributions, unless the third-party SNT drafting attorney is well versed in tax law, the attorney should make sure that the donor's regular estate planning attorney and other financial and tax advisors are involved in the process. See § 2.03.

[4] 529 Plans

[a] 529 Plans

Under the enabling legislation[1] 529 Plans exist to pay for the plan beneficiary's qualified higher educational expenses as defined in the statute and regulations.[2] One of the major advantages of using a 529 Plan is that the donor is not restricted to the annual gift tax exclusion amount. The donor may "stack" up to five (5) years of gifts at one time, which allows the donor to make a gift of $65,000 (assuming the annual exclusion amount is $13,000) at one time (or $130,000 for a married couple).[3] If done this way, the donor must survive the five (5) year period[4] and regardless of whether gifts are "stacked" or not, all contributions to 529 Plans must be in cash.[5]

529 Plans exist in every state and the District of Columbia and each one is slightly different. There is no requirement that the donor or the beneficiary be a resident of the state in which the Plan is established. Therefore, if this technique is to be utilized, the drafting attorney must ascertain certain information before committing the trustee of the SNT to a specific 529 Plan. Among other things, the attorney should determine:

- Does the 529 Plan authorize a trust to be the owner of the Plan? While the statute does not prohibit trusts from establishing 529 Plans,[6] not all state plans permit it.
- What is the maximum amount that can be contributed to the 529 Plan? Each

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[11] I.R.C. § 1015(a).

[12] I.R.C. § 1014(a), 1015(a).

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[1] I.R.C. § 529.

[2] I.R.C. § 529(e)(3)), Reg. § 1.529-1(c). For more information on 529 Plans in general, see Burke, Friel, Gagliardi, *Modern Estate Planning* (Second Edition) ch. 2 (Matthew Bender).

[3] I.R.C. § 529(c)(2)(B).

[4] I.R.C. § 529(c)(4)(C).

[5] I.R.C. § 529(b)(2).

[6] I.R.C. § 529(b)(1)(A); I.R.C. § 7701(a)(1); Prop. Reg. § 1.529-1(c).

state is required to adopt procedures that prevent a plan from being funded with more than is deemed necessary to pay for the 529 Plan beneficiary's qualified higher education expenses.[7] This is significant since the maximum amounts currently range from a low of $200,000 to as much as $400,000. While a person can be a beneficiary of multiple 529 Plans, it makes more sense to choose a Plan that allows the maximum flexibility at the outset rather than have to set up multiple accounts later on.

- Does the SNT beneficiary qualify as a person with a disability under the 529 Plan? This question is important if the major purpose of utilizing a 529 Plan is as a funding vehicle (i.e., maximizing the use of the gift tax annual exclusion) as opposed to actually funding qualified higher education expenses. While the statute provides that distributions made other than for qualified educational expenses are penalized, it further provides that the penalty is not assessed where the beneficiary has a disability.[8]

[b] Distributions To and From 529 Plans

When the beneficiary of the SNT is able to pursue higher education notwithstanding her disability, using a 529 Plan funded from a third-party SNT can be very advantageous. Distributions from a 529 Plan for qualified higher education expenses are not considered income to the beneficiary and are excluded from calculating gross income for federal income tax purposes.[9] On the other hand, a distribution that does not qualify as a qualified higher education expense is considered taxable income.[10] However, as noted above, distributions for non-qualified expenses are not subject to the 10 per-cent penalty under Section 529(c)(3)(B)(i) when the beneficiary has a disability.[11]

The statute and regulations define "qualified higher education expenses" as:

- Tuition, fees, books, supplies and equipment required for enrollment or attendance at an eligible institution;
- Room and board (as long as the beneficiary is carrying a at least 50% of the course load required for full-time enrollment);
- If the beneficiary/student has special needs, the expenses for the services connected with those special needs necessary for attendance at the institution.[12]

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[7] I.R.C. § 529(b)(6); Prop. Reg. § 1.529-2(i)(1).

[8] I.R.C. § 529(c)(6); Prop. Reg. § 1.529-2(e)(4)(ii)(B)(1)-(2).

[9] I.R.C. § 529(c)(3)(B)(i).

[10] I.R.C. § 529(c)(3)(A).

[11] I.R.C. § 529(c)(6); Prop. Reg. § 1.529-2(e)(4)(ii)(B)(1)-(2).

[12] I.R.C. § 529(e)(3); Prop. Reg. § 1.529–1(c).

CHAPTER 3

Sources of Assets to Establish Special Needs Trusts

SYNOPSIS