PRE-CONFERENCE:
TAX INTENSIVE

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The Interplay of Income, Estate and Gift Tax

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- Materials
- PowerPoint

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STETSON UNIVERSITY
Center for Excellence in Elder Law
ACCESS AND JUSTICE FOR ALL®
THE INTERPLAY OF INCOME, ESTATE AND GIFT TAX

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THE INTERPLAY OF INCOME, ESTATE AND GIFT TAX

I. Income Tax

A. Individual Income Tax. When making decisions for clients regarding Medicaid and special needs planning, one must keep in mind that there may be individual income tax consequences to those decisions.

1. Qualified Income Trusts. Medicaid rules differ from state to state, but one way or another, the monthly income of a Medicaid recipient is taken into account. If the income is determined to be too much for eligibility, the states have invented methods to allow eligibility while reducing countable income. Now federal law provides for these “qualified income trusts.” When a qualified income trust is funded, it is common practice for all of the income of the Medicaid recipient to be directed into the trust. Once a month, the Trustee issues checks. In some states, these checks are for a precalculated amount of income that represents the maximum allowable amount to be deemed to be available to the Medicaid recipient. In other states, this amount is the entire corpus of the trust. This amount is used to pay for the cost of care at the nursing home, the personal needs allowance and any allowable trustee fees, among other things. Either the balance of the income remains in the trust or the entire amount is spent. At the death of the Medicaid recipient, the balance in the trust, if any, is paid to Medicaid to reimburse Medicaid for any monies that have been expended by Medicaid for the care of the recipient.

1 42 USC § 1396p d(4)(B)
If the Medicaid recipient has sufficient income, he or she may have an income tax liability on the income diverted to the trust. However, even though the income that is being directed into the trust may be taxable income, there is no provision in the qualified income trust arrangement for any money to be set aside to pay an income tax liability. For single Medicaid recipients, even after taking a medical deduction for the funds paid to the nursing home, if there is an income tax liability, the only solution is for a family member to contribute the funds that may be required to pay the income tax liability.

For a married Medicaid recipient, one solution to this problem is to have the income of the Medicaid recipient be deposited first into a joint account. The community spouse can then issue a check from that account each month to the qualified income trust. On the joint individual income tax return, the community spouse can report the joint income, and take a medical deduction for the amount used from the joint income of the couple for the cost of care of the Medicaid recipient, thus reducing the taxable income of both taxpayers. If there is any income tax liability, it can be paid from the income of the community spouse.

2. **Timing of Liquidation of Retirement Plans.** If a retirement plan such as an IRA has to be liquidated in order for the Medicaid recipient to be eligible, it is important to consider the timing of that liquidation so as to minimize the income tax liability on that liquidation. What is advisable is to have the liquidation occur after the Medicaid applicant has entered a skilled nursing facility but before eligibility for Medicaid. The cost of the skilled nursing facility will be an income tax deduction for medical care which can be taken against the taxable income realized by the liquidation of the IRA.
Additionally, one must take into account the income tax consequences of annuitizing an IRA, which is a safe harbor under the Deficit Reduction Act of 2005.\(^2\) All distributions from IRA’s are ordinary income. Therefore, when an IRA is annuitized in order to obtain Medicaid eligibility, one must take into account that each regular payment from an IRA to the spouse of a Medicaid recipient will be included in his or her taxable income as ordinary income.

**B. Fiduciary Income Tax.** Trusts are commonly used for Medicaid planning. It is important to know about the income taxation of trusts so that one does not overlook planning opportunities that may be available.

1. **Income Only Trusts.** If a trust has been established for the benefit of the Medicaid recipient that by its terms may only distribute income to or for the benefit of the Medicaid recipient, the trust itself will not owe income tax, because all of its income will be distributed currently. This is called a Simple Trust. (The trust may owe capital gains tax if it has realized a gain on the sale of an appreciated asset, and by its terms is not required to distribute that gain as income to the beneficiary.) The trust will need to file an income tax return, which is filed on Form 1041, U.S. Income Tax Return for Estates and Trusts. The trustee reports how much income was earned by the trust and that the trust has distributed all of its income, and along with the return, the trustee files a Schedule K-1 that reports the amount of income that was distributed during the previous tax year to the beneficiary of the trust. Federal fiduciary income tax returns are due on April 15 of the year following the tax year. All trusts use the calendar year as their tax year.

2. **Discretionary Trusts.** Special Needs Trusts as well as traditional support trusts will result in many people being beneficiaries of discretionary trusts. Because there is no

\(^2\) 42 USC §§ 5001 et. seq.
requirement that income be distributed currently, these are called Complex Trusts. As with Simple Trusts, the Trustee must file an income tax return that reports the amount of income, if any, that was earned and distributed during the tax year. This is called distributable net income ("DNI") and it can be one of the most confusing concepts in fiduciary accounting. In addition, if the trustee distributes principal, but the trust earned income during the tax year, the value of the principal, up to the amount of the accounting income of the trust for that year, will be considered to be a distribution of income. A simple way to explain this is to state that any principal distribution “drags out” income up to the value of the principal distributed. For example, if the trustee purchases an elephant for the beneficiary, which is worth $20,000, and the trust earned $18,000 in income in the tax year, the trustee would report that it distributed $18,000 in distributable net income to the beneficiary, and the trust would have no income to report that it retained. For that tax year, the trust would be a simple trust. If the earned income of the trust was higher than $20,000, and the trustee made no other distributions during the tax year, the trust would report that it distributed $20,000 income to the beneficiary and retained the balance of the income over $20,000, minus a $100 exemption that is available to complex trusts. The trust would owe income tax on that balance, and would also file a Schedule K-1 reporting a $20,000 distribution of income to the beneficiary. The beneficiary, who received an elephant, would have to file an income tax return reporting the $20,000 distribution as taxable income.

Trusts pay income tax at the same rates as individuals. However, the brackets of trusts are very compressed. For 2015, the projected rates and brackets are as follows:

<table>
<thead>
<tr>
<th>2015: If Taxable Income Is:</th>
<th>The Tax Is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $2,500</td>
<td>15% of the taxable income</td>
</tr>
<tr>
<td>Over $2,500 but not over $5,900</td>
<td>$375 plus 25% of the excess over $2,500</td>
</tr>
<tr>
<td>Over $5,900 but not over $9,050</td>
<td>$1,225 plus 28% of the excess over $5,900</td>
</tr>
</tbody>
</table>
As you can see, a trust that retains $20,000 in earned income will pay $6,514 in federal fiduciary income tax at the 39.6% rate plus the Medicare surtax, after taking the $100 exemption allowed. In comparison, a single individual reporting $20,000 of taxable income will pay tax at the maximum 15% rate, which will be further reduced by the individual exemption of $4,000 in 2015. The tax bill that results from the distribution of the elephant to the individual beneficiary will be 0. All the more reason for the trustee to purchase an elephant for the beneficiary! For an individual to pay income tax at the highest rate of 39.6%, the taxable income must be higher than $413,201.

3. **Special Needs Trusts.** Special Needs Trusts are complex trusts, because the trustee must use its discretion before distributing income or principal. Being a complex trust, any time that the trustee distributes principal, the value of the principal distributed “drags out” the value of any earned income in the trust and there is a distribution of income to the beneficiary. This seems anomalous, when we know that beneficiaries of special needs trusts are usually receiving means based benefits, such as Supplemental Security Income, and are not allowed to receive income. One must remember that the definition of income for Social Security and Medicaid purposes is different than the definition of taxable income. Using the example of the distribution of an elephant, which is arguably not a countable resource as a pet or household item, it would not affect the income limitations of the beneficiary. However, because it “drags out” income from the trust, there is taxable income reported to the Internal Revenue Service for the beneficiary. The Trustee of a special needs trust will commonly arrange for the preparation
of an income tax return for the beneficiary, pay the expense of the preparation, and pay any income tax liability of the beneficiary.

If a special needs trust retains income, the Internal Revenue Code (“IRC”) provides an exception for some special needs trust beneficiaries. It was introduced in the Victims of Terrorism Tax Relief Act of January, 2002. It provides for a higher exemption if the trust is what is defined as a Qualified Disability Trust (“QDT”), that is, one that is established solely for the benefit of an individual under 65 who is disabled. A trust is a QDT even if a remainder beneficiary is not disabled. A special needs trust for a person over age 65 that was funded after age 65 would not qualify as a QDT. For a trust that meets the definition of a QDT, the exemption that is allowed for the trust is the allowable personal exemption for the individual beneficiary. In 2015, the personal exemption is $4,000. Therefore, if a QDT retains $5,000 of earned income, after the exemption amount, it would report $1,000 taxable income, and pay $150 income tax. A complex trust that is not a QDT would have only a $100 exemption, and thus would report $4,900 taxable income and pay $975 in tax.

4. Grantor Trusts. In our practices, we usually associate the term “Grantor” with the person who creates a trust. We understand that this term can be substituted with the terms “Trustor” or “Settlor.” However in the IRC, the term “grantor” has a specific meaning that is somewhat broader than what we are accustomed to. In Treasury Regulation Section 1.671-2(e)(1), the term “grantor” for the purposes of the grantor trust rules can be a person who creates a trust (a meaning with which we are comfortable) or a person who makes a gratuitous transfer to a trust, directly or indirectly. Therefore, a person who creates a trust and has the title of Grantor according to our common meaning of the term might fit one of the

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3 IRC § 642(b)(2)(C)(i), (ii)
4 Treas. Reg § 1.671-2E(1)
definitions of grantor under the IRC. However, there can be additional grantors under the IRC who are persons who gratuitously transfer anything into that trust. The additional grantors can become such by either a direct transfer or an indirect transfer. What would that look like? Let’s say that a parent created an irrevocable trust for a child. The parent is of course the Grantor or creator of the trust. Somewhat later, a grandparent decides to make a gift to the trust for the benefit of the child. The grandparent may also be a grantor, even though the grandparent did not create the trust.

Under the IRC, once a person has become a possible grantor by creating the trust or donating to the trust, if the terms of the trust establish sufficient control in such person, then the person is deemed to be the owner of the trust property, not the trust. Thus the grandparent who transferred property in the above example could be treated as the continuing owner of the transferred property, depending on the terms of the trust. For income tax purposes, the grantor is taxed on the income earned by the property in the trust of which the grantor is deemed to be the owner. The trust is ignored for income tax purposes and the income is treated as if it were distributed to the grantor, even if it is not actually distributed to the grantor. In the example of the transfer from the grandparent, if the grandparent is a grantor, the income earned by the assets in the trust that were contributed by the grandparent is attributed to the grandparent for income tax purposes. Therefore, if a drafter wants income to be attributed to the person who establishes a trust, or to persons who contribute assets to the trust but who did not create the trust, then the drafter needs to make sure that the terms of the trust agreement provide sufficient control in the grantor to establish a grantor trust.

The Grantor Trust Rules are found at Sections 671 to 678 in the Code and in the accompanying Treasury Regulations at Sections 1.671-1 to 1.678-(a)1 et.seq..
5. Estates. An estate can also earn income. If an estate earns more than $600 of gross income during any fiscal year, it will need to file an income tax return. Estates generally will distribute all income at the end of administration, but may or may not distribute income during administration. Estates have the same income tax rates as trusts. However, estates have great flexibility to determine fiscal years. Depending on the circumstances, the Personal Representative may determine that the appropriate fiscal year for an estate may be a short year for the first year, and/or a short year for the final year. The only parameters guiding the choice of fiscal year are that it cannot be longer than the period from the date of death until the end of the month in the next year that immediately precedes the month of death. For example, if a decedent died on November 15, 2013, the maximum length fiscal year would be from November 15, 2013 until October 31, 2014. It is not uncommon for the Personal Representative to elect a short first fiscal year, in order to make maximum use of deductions that the estate can take that are not available to the beneficiaries, such as the expenses of administration.

II. Capital Gains Tax

A. Basis of Property Transferred by Sale. Property often must be liquidated as part of the spenddown to prepare for Medicaid eligibility or a trustee many need to sell property. The practitioner must be aware that a sale of appreciated property will realize capital gain. If the property has been held for more than 12 months, it will be subject to long term capital gain tax. The capital gain is calculated by subtracting the adjusted basis from the adjusted sale price. For real property, the adjusted basis is the amount that was paid for the property when it was purchased by the taxpayer (cost basis), reduced by any depreciation taken during the time that the property was held, and increased by the cost of any capital improvements made to the property. The adjusted sale price is the price paid for the property by the buyer reduced by any
costs of sale that were paid by the taxpayer. For sales of long-term capital gain property in 2015, if the seller is in the 10% or 15% income tax bracket, the capital gains tax rate is 0%. If the seller is in the 25% to 35% income tax bracket, the capital gains tax rate is 15%. If the seller is in the 39.6% income tax bracket, the maximum capital gains rate is 20%. The rates are the same for individuals as well as trusts.

B. **Basis of Property Transferred by Gift At Death.** When an appreciated asset transfers as a result of the death of the owner, the basis steps up to the fair market value as of date of death.\(^5\) Therefore, anyone who inherits appreciated property will also receive a new basis in the property. In community property states, the basis of the entire property will step up if community property is inherited by a surviving spouse.\(^6\)

C. **Basis of Property Transferred by Gift During Lifetime.** A spend down plan may include making transfers of appreciated property to another person. When a person makes a gift of appreciated property to another person, the basis of the property transfers with the property. Therefore, whatever was the adjusted basis of the transferor becomes the carryover basis of the transferee. For example, father transfers a rental house to daughter. The value of the house when father bought the property was $50,000. While he owned the property, he took depreciation in a total amount of $10,000. He added an addition on the house for $5,000. Therefore, his adjusted basis in the property is

\[
\begin{array}{ccc}
\$ & 50,000 & \text{cost of purchase} \\
- & 10,000 & \text{depreciation} \\
+ & 5,000 & \text{capital improvements} \\
\hline
\$ & 45,000 & \text{adjusted basis}
\end{array}
\]

\(^5\) IRC § 1014(b)  
\(^6\) IRC § 1014(b)(6)
If daughter holds the property, she may continue depreciation, but she must use her father’s basis. When daughter sells the property, she will realize capital gain and pay tax on the difference between her adjusted sale price and her adjusted basis. If she sells the property for $100,000, with costs of sale of $5,000, and having taken $5,000 in depreciation, her gain will be $45,000.

\[
\begin{array}{c|c}
\text{sale price} & \$100,000 \\
\text{cost of sale} & - 5,000 \\
\hline
\text{adjusted sale price} & \$95,000 \\
\end{array}
\]

\[
\begin{array}{c|c}
\text{carryover basis} & \$45,000 \\
\text{depreciation} & - 5,000 \\
\hline
\text{adjusted basis} & \$40,000 \\
\end{array}
\]

\[
\begin{array}{c|c}
\text{adjusted sale price} & \$95,000 \\
\text{adjusted basis} & - 40,000 \\
\hline
\text{taxable gain} & \$45,000 \\
\end{array}
\]

What if father transfers real property to himself and daughter as joint tenants with the right of survivorship? The Internal Revenue Service and Medicaid consider this to be a completed gift from father to daughter of one-half of the property, because once the deed is executed and delivered to daughter, father cannot sell the property without her permission. Daughter’s carryover basis in her one-half of the property is one-half of father’s basis. If father dies, his one-half interest will pass to daughter, and she will obtain a stepped-up basis for father’s one-half. If the property value is $100,000 at the time of the gift and at father’s death, and father’s basis was $45,000 at the time of the gift, and there were no subsequent adjustments to basis during his lifetime, daughter’s basis at her father’s death is $72,500, that is, $50,000 (father’s new basis) plus $22,500 (daughter’s basis in one-half of property).
D. **Inheriting a Life Estate.** Dad dies, leaving his home to his daughter. However, he had a surviving spouse, and the law of his state provides that the surviving spouse, who is daughter’s stepmother, receives a life estate in the home, and daughter obtains only a remainder interest. At the death of stepmother, what is the value of daughter’s basis in the house?

The section of the IRC that applies is Section 1001(e)(1), which states that in determining the gain or loss from the sale or other disposition of a term interest which is obtained as a result of another’s death, the adjusted basis of that term interest shall be disregarded. In plain English, this means that although the basis of a term interest can be determined upon receipt using actuarial tables, if it is sold or if it passes as a result of the life tenant’s death, the basis is zero. The regulations pertaining to this IRC section (Treas. Reg. 1-1001-1(f)(4)) refer to another place in the Regulations for examples, Treas. Reg. 1.1014-5(c). Looking at these examples, except for one exception, we find that a disposition of a term interest that is acquired as a result of a gift at death or during lifetime, results in a basis of zero. Thus, the result for our example is that daughter’s basis is the value of her remainder interest in the property at the time of her father’s death.

There is an exception to calculating gain or loss with a zero basis for a term interest acquired by death or gift. If the owner of the life interest and the owner of the remainder interest later dispose of the entire property to a third party, then the basis of the term interest does have a value of more than zero. But the value of the basis is calculated not as of the time of receipt, but as of the time of the disposition, because the age of the life tenant has increased. This is called the Shifting Basis Rule, and can be found in the Regulations at Sections 1-1014-5(a) and

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7 See IRC § 1001(e)(3)
1-1015-1(b). What we learn here is that when one receives a term interest either from a decedent (Section 1014) or by gift during lifetime (Section 1015), the value of that interest is calculated using actuarial factors based on the life tenant’s age.

Therefore, when our stepmother obtained her life interest, the basis of her life interest was a percentage of the total value, calculated using factors to determine the present interest based on her age at the time of dad’s death. The value of the daughter’s remainder interest, and thus her basis, is calculated by subtracting the value of stepmother’s life interest from the total value. But as stepmother aged, the value of her basis shifted at time passed. Once again, if stepmother disposed of her interest during her lifetime to a third party, or if she died without disposing of her life interest, the basis is calculated as zero. But if stepmother and daughter decided to sell their combined interests, then stepmother could use her basis to calculate gain or loss, and she would determine her basis using the factor for her age at the time of the sale multiplied against the value of the property when she acquired her interest. Thus the value of the basis in a term interest “shifts” as the life tenant ages, and the value of the basis of the owner of the remainder interest is increased.8

E. Principal Residence Exclusion from Capital Gain. Section 121 of the IRC states that an individual taxpayer can exclude from income up to $250,000 of gain from the sale of a home owned and used by the taxpayer as a principal residence for at least 2 of the 5 years before the sale. The full exclusion does not apply if, within the 2-year period ending on the sale date, the exclusion was applied to another home sale by the taxpayer.

A married couple filing jointly for the year of the sale may exclude up to $500,000 of home-sale gain if (1) either spouse owned the home for at least 2 of the 5 years before the sale,

8 See examples (3) and (4) in Treas. Reg. 1-1014-5(c)
(2) both spouses used the home as a principal residence for at least 2 of the 5 years before the sale, and (3) neither spouse is ineligible for the full exclusion because of the once-every-2-year limit.

III. Federal Gift Tax

The IRC imposes a tax on certain gratuitous transfers, meaning transfers during lifetime for which the donor receives nothing in return.\(^9\) The gift tax is an excise tax assessed on the net value of the gift on the date of the gift. Not all gifts are taxable. Gifts which are not taxable include: annual gifts of a present interest valued at no more than $14,000; gifts to spouses who are United States citizens; gifts to charities; tuition paid for someone else if paid directly to the educational institution; medical expenses paid directly to the provider; and, gifts to political organizations. For a gift tax to be imposed, a transfer must be a completed gift, that is, out of the control of the transferor. The rate for gift tax in 2015 is 40%. When a lifetime transfer of appreciated property is made, the basis of the property transfers with the property.\(^10\)

A. Direct Lifetime Transfers of Gifts. A gift of $14,000 or less of a present interest to a donee in a calendar year is not taxable or required to be reported. A person can make a series of non-taxable gifts to any number of individuals in the same calendar year. A married couple can make a non-taxable gift of up to $28,000 to an individual. A married couple can make a gift to another married couple, such as their child and his or her spouse, which can total up to $56,000 without the gift being taxable or reportable.

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\(^9\) See IRC §§ 2501-2524  
\(^{10}\) IRC § 1015(a)
When a person makes a taxable gift, however, the IRC requires that a gift tax return be filed using Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return. Unless the total cumulative taxable gifts made by a donor exceed $5,430,000 in 2015, no gift tax must be paid even though filing a return is required. Therefore, a person can give up to $5,444,000 ($5,430,000 + $14,000) to another person in one year and still not have to pay gift tax. Gift tax returns are due by April 15 of the year following the year in which the gift was made. Gift tax is payable by the donor.

B. Transfers of Gifts to Trusts.

1. Gifts of Future Interests. If a gift has a condition on it, or if it cannot be spent currently by the donee of the gift, it is a gift of a future interest rather than a present interest. The $14,000 annual exclusion for non-taxable gifts only applies to gifts of a present interest, that is, a gift that has no conditions and that can be used immediately by the donee. Gifts to irrevocable trusts are usually gifts of a future interest, that is, the gift will not be immediately distributable to the beneficiary but will be distributed at a future date according to the terms of the trust. For example, a transfer to a trust for the benefit of a minor is a gift of a future interest, because the minor will not have a power to demand distributions until attaining a certain age. Transfers to trusts in which the trustee has discretionary power over all distributions will always be transfers of a future interest. Therefore, transfers in any amount, even less than $14,000, to discretionary trusts, are taxable gifts.

2. Crummey Powers. In 1968, a couple named Mr. and Mrs. Crummey challenged the IRS on this issue of transfers to trusts being future interests. Mr. and Mrs. Crummey had made transfers to an irrevocable trust for their children, two of whom were

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11 Crummey v. Commissioner, 397 F. 2d 82 (9th Circuit, 1968).
minors. The trust was governed by California law. California law at the time provided that a
beneficiary of a trust had until the end of the calendar year of the year of the gift to withdraw that
transfer, and that after the end of the calendar year, the gift became part of the trust. The IRS
took the position that the transfers to the trust were gifts of future interests. Mr. and Mrs.
Crummey argued that for the period of time that the child had the right to withdraw the gift, it
was a gift of a present interest. Since this period began at the time of the transfer and lasted until
the end of the year, then at the time of the gift, it was a present interest. The court agreed with
the Crummeys. As a result of that case, when a transfer to an irrevocable trust is made, the
trustee can be directed to notify the beneficiaries of the trust that they have a certain limited
period of time in which they have the right to withdraw the amount transferred, or a pro rata
portion of it. This is now called a Crummey notice. The power conferred to the beneficiaries is
called a Crummey power. If the beneficiary does not exercise the Crummey power, then the gift
remains in the trust and becomes subject to the discretion or other powers of the trustee.

A subsequent case gave these withdrawal powers to persons other than the present
beneficiary of the trust.\textsuperscript{12} Ms. Cristofani gave the power to withdraw contributions to her two
children and also to five grandchildren, and the grandchildren were only remainder beneficiaries
of the trust. The Tax Court agreed that the gifts to the trust were not taxable.

3. Transfers to Special Needs Trusts. Special needs trusts are commonly
used to protect assets that either belonged to a disabled recipient or that are given to a trust by
someone other than the recipient to provide for his or her special needs.

a. Transfers to d(4)(A) Special Needs Trusts. A d(4)(A) special
needs trust is funded with assets that belong to the beneficiary, and thus is considered a grantor

\textsuperscript{12} Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991)
trust. These trusts are also called “payback trusts,” because at the death of the beneficiary, Medicaid is entitled to be reimbursed from the remaining assets in the trust up to the amount spent by Medicaid for his or her care during the lifetime of the beneficiary. Because the transfer into the trust is of the beneficiary’s own assets, and the beneficial interest in the trust is retained by the beneficiary, the trust is a grantor trust and there is not a completed gift to the trust that occurs. Therefore, there are not gift tax considerations for d(4)(A) trusts.

b. Transfers to Third Party Settled Trusts. Transfers by third parties to special needs trusts are gifts of a future interest, because the trustee is prohibited from distributing income or principal except for the beneficiary’s special needs. Furthermore, because the beneficiary has severe restrictions on the amount of income that he or she can receive during any month, as well as restrictions on the amount of resources that can be owned by the beneficiary, the beneficiary cannot have a present right to demand a withdrawal of any asset of the trust. Therefore, a Crummey power cannot be given to the beneficiary of a special needs trust. Therefore, any transfers of any amount to a special needs trust will be a gift of a future interest, which is a taxable gift that must be reported on a gift tax return.

One way to overcome this problem is to name other members of the family as additional beneficiaries of the trust for Crummey power purposes only. A special needs trust must have only one beneficiary. Therefore, the trust must be drafted so that it excludes the disabled beneficiary from having a Crummey power but lists other beneficiaries who are available to withdraw transfers to the trust. Furthermore, the trust could provide that while all of the named beneficiaries may receive discretionary distributions as long as the disabled beneficiary is not eligible for or receiving public benefits, when the disabled beneficiary is eligible for or receiving public benefits, he or she is to be the sole beneficiary of the trust. Alternatively, the trust
document could establish separate subtrusts for each of the beneficiaries, and direct the trustee to fund the subtrust for the disabled beneficiary with most of the assets of the trust. After the period for Crummey powers has elapsed, the subtrust for the disabled beneficiary would of course be a special needs trust. Using either of these methods would result in Crummey powers being available for transfers to the trust, and thus the transfers would be gifts of present interests.

In 2015, the gift tax exemption is unified with the federal estate tax exemption. This means that if one does make a taxable gift, even though there may be no gift tax to be paid, one has used up some of the exemption. For example, if one funds a third party-settled special needs trust with $100,000, all of which its taxable, and files a Form 709 reporting that gift, the consequence is that the federal gift tax exemption remaining has been reduced by $100,000 to $5,330,000. This exemption amount is now also the amount remaining for federal estate tax purposes.

One issue to consider is whether or not the client even wants to make a completed gift to a third party-settled trust, because the client wants to pay all of the income taxes of the trust, meaning that the client wants the trust to be a grantor trust. Generally, a transfer to a grantor trust is not a completed gift, because the grantor retains control of the trust assets. However, if a client also wants to reduce his or her taxable estate for federal estate tax purposes, and the trust is being considered as a vehicle for gifting assets from the client to others, then the best advice is for the client to make a completed gift to a trust that would exclude the assets from his or her federal taxable estate at death. There is a hybrid use of grantor trust status that can accomplish both goals, that is, having transfers to the trust be completed gifts for gift tax purposes and retaining grantor trust status for income tax purposes. These trusts are referred to with the odd name, Intentionally Defective Grantor Trusts (“IDGT”). The trust is a grantor trust, often
containing the administrative power of the grantor to substitute trust property of equal value. All other aspects of the trust provide for complete separation of control by the grantor. Thus the grantor trust is “defective,” because control by the grantor is so limited. A gift to an IDGT is a completed gift. Using an IDGT, which can be a special needs trust, can enable a grantor to pay the income tax liability for the trust as well as treat the trust assets as entirely separate from the grantor’s taxable estate for federal estate and gift tax purposes.

IV. Generation-Skipping Transfer Tax

A subset of the federal gift tax and the federal estate tax is the Generation-Skipping Transfer Tax (“GST”). This is an extra tax on lifetime gifts or gifts from a decedent if the gift transfers to a “skip person,” meaning to a person in a generation below another living person. For example, if grandpa wants to give a gift to grandchild, and the parent of grandchild who is a child of grandpa is alive, grandchild is a skip person. In this example, if the gifts exceeds the value of the remaining gift tax exemption amount available to grandpa, then there will be gift tax as well as GST tax assessed. The exemption amount for the GST tax is the same amount as the gift and estate tax exemption.

V. Federal Estate Tax

The federal estate tax is an excise tax assessed on property that passes at the death of the owner to his or her beneficiaries. Property that is subject to the federal estate tax is that property over which the decedent had control at death or held a power that gave him or her sufficient control to cause inclusion in the federal taxable estate. Similar to the gift tax, there are some transfers that are exempt from tax, notably transfers to a spouse and to charities. The rate

\[13\] IRC §§ 2601-2664

\[14\] IRC §§ 2001-2058
for the federal estate tax in 2015 is 40%, assessed on the net value of the assets as of the date of death. The exemption amount for the federal estate tax is $5,430,000 in 2015, meaning that an estate valued at less than that is not subject to the tax.\textsuperscript{15} Although the exemption amount is very high, there are circumstances when one should take the federal estate tax rules into account. For example, even if an estate value is below the exemption amount, when appreciated property transfers as a result of death, the basis “steps up” to the value of the property at the date of death, thus reducing capital gains tax on inherited assets.\textsuperscript{16}

A. Special Needs Trusts.

1. Self-settled d(4)(A) Special Needs Trusts. It is not uncommon for a plaintiff to obtain a settlement of a significant amount as a result of injuries sustained by someone’s negligence. In these cases, if the plaintiff has been permanently disabled as a result of the incident and will require substantial medical care for the rest of his or her life, it is appropriate to direct the settlement recovery to a special needs trust in order to secure eligibility for Medicaid for the plaintiff. Under Medicaid rules, funds received in a recovery are deemed to belong to the plaintiff. Therefore, the only kind of special needs trust that can be used in this planning is a d(4)(A) trust as long as the plaintiff is disabled and under age 65. For tax purposes, this trust is includable in the plaintiff’s taxable estate, because he or she transferred the funds while retaining an interest in the funds, even though that interest is subject to the discretion of the trustee. Because of the payback requirement to Medicaid, however, if the medical needs of the beneficiary are substantial, it is likely that the corpus of the trust will be reduced significantly at the death of the beneficiary in order to pay the debt to Medicaid. While this may be the case,

\textsuperscript{15} The Taxpayer Relief Act of 2013 provided for a new concept called “portability” by which any leftover exemption amount in the estate of one spouse can be transferred to the surviving spouse.

\textsuperscript{16} IRC 1014; Treas. Reg. 1.1014-1
however, it is important that the practitioner not overlook traditional estate planning techniques to reduce federal estate tax when drafting a special needs trust that will hold a recovery over $5,430,000 in 2015.

2. **Third Party Settled Special Needs Trusts.** A special needs trust that is funded by a third party should take into account traditional federal estate tax planning techniques as well. While the third party special needs trust may not be includable in the estate of the beneficiary, it is important to consider the remainder beneficiaries when drafting these trusts. A third party-settled special needs trust can include generation-skipping transfer tax exemption planning so that at the death of the beneficiary, his or her children, or the other issue of the grantor, can benefit from generation-skipping tax exemption planning. If a beneficiary of a special needs trust is able to access public benefits, and if most of the needs of the beneficiary are provided by such benefits, it is likely that the special needs trust can grow in value and may not be expended during the life of the beneficiary. One can include a limited power of appointment for the beneficiary, if he or she is competent, which will not cause inclusion of the trust in his or her taxable estate, but will provide for some control over the future of the trust corpus, particularly if the beneficiary has children. By keeping in mind that this planning should benefit others in the future, a practitioner can provide good advice to a wealthy client who wants to provide significant funds that will be there if needed for a disabled family member, but will also provide prudent estate planning for other people for whom the grantor may wish to provide.

**Conclusion**

When planning for clients who lack capacity or may have other disabilities, providing for their special needs is paramount. However, the rules for income taxation, both for trusts and for
estates and individuals, must be considered. Interrelated with the income tax rules are the rules for capital gains, gifts and for the transfer of property at death.