This is the second half of a two part article on the Taxation of Special Needs Trusts.

Taxation of Special Needs Trusts

By Dennis Sandoval, CELA

C. Grantor Trust Rules

Certain powers, held by the grantor or the trustee or others can cause the trust to be a "grantor trust" under the Internal Revenue Code. A grantor trust is taxed to the grantor as though it were the same person. A trust may be a grantor trust as to the income, the principal, or both. If a trust is a grantor trust, it is taxed to the grantor, including all items of income, deduction, etc.

The grantor trust rules are exceedingly complex. It is much easier to make a trust a grantor trust than it is to ensure that it is not a grantor trust during the life of the grantor.

The following powers cause a trust to be a grantor trust:

Section 673— Reversionary Interest. If the grantor retains a reversionary interest in the trust that is worth 5 percent or more of the value of that interest, this causes the trust to be a grantor trust. An example of a reversionary interest would be "income to Mary for life and principal to Mary or Mary's estate if she survives the grantor, otherwise to the grantor." Assuming that there is at least a 5 percent chance that the grantor will outlive Mary, the trust is a grantor trust. Because this type of provision could cause trust assets to be characterized as available or subject to recovery by the Department of Health Services, this type of provision should never be included in a Special Needs Trust.

Section 674 — Power to Control Beneficial Enjoyment. This section covers situations in which someone has a "power of disposition." Such a power could include the right to distribute income or principal of from the trust. The power could be held by a trustee. However, for most purposes of this section, the power could be held by someone else, such as the holder of a limited power of appointment.

Internal Revenue Code § 674(a) provides:

The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party,[1] or both, without the approval or consent of any adverse party.[2]

This power is often created by the insertion of a limited or special power of appointment[3] into the Special Needs Trust. Note that the grantor who holds a limited power of appointment does not actually have to have the physical or mental capacity to actually exercise the power in order

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to create grantor trust status; the grantor need only have the right to exercise it. This is especially important when drafting First Party Special Needs Trusts where the grantor-beneficiary lacks such capacity.

A power exercisable only by Will "other than a power in the grantor to appoint by Will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a non-adverse party, or both, without the consent or approval of any adverse party"[4] is an important exception to Internal Revenue Code § 674(a) that is relevant to drafters of Special Needs Trusts. The provision appears to make the insertion of a testamentary limited power of appointment into a SNT not sufficient to cause the SNT to attain grantor trust status. The perception is not correct, however. The Internal Revenue Code makes reference to two types of income — accounting income and ordinary income. When the Code refers to "income" it is referring to accounting income, which includes capital gains. Ordinary income, which is referred to as such under the Code, is limited to items as such as interest, dividends and rent. Because a Special Needs Trust will accumulate ordinary income and capital gains and add them to the principal of the trust, if not distributed to the special needs beneficiary on a discretionary basis, the grantor's use of a limited power of appointment should create grantor trust status.

Further support for the position that a testamentary limited power of appointment can be used in a Special Needs Trust to create grantor trust status can be found at Treasury Reg. § 1.674(b)-1(b)(3), which states:

[I]f a trust instrument provides that the income is payable to another person for his life, but the grantor has

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A power that is sometimes given to create grantor trust status is the power to add charitable beneficiaries to receive a portion of the trust remainder after the death of the special needs beneficiary. If given to an independent party, such as a trust protector, this power will create grantor trust status.[6]

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Grantor trust status has some obvious and some less obvious implications. The grantor must pay the tax, which means of course that the trust need not pay the tax. Income from the trust is reported on the grantor's personal income tax return. When set up for estate tax planning reasons, this has the effect of allowing the assets in the trust to grow income-tax-free. Essentially, this is the equivalent of the grantor transferring the amount of the income tax to the trust without paying gift taxes. The grantor is not making a gift to the trust by paying the trust's income tax when the grantor has a legal obligation to do so and there is no right of reimbursement.[13]

a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion.

Of course, greater certainty that a grantor trust is created can be achieved by using a lifetime limited power of appointment, rather than a testamentary one, when creating the Special Needs Trust.

Another exception is Internal Revenue Code § 674(b)(5)(A), which states the general rule shall not apply to:

A power to distribute corpus . . . to or for the beneficiary or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument.

Given that a SNT should be drafted with fully discretionary distribution language with no standard present, the exemption should be inapplicable. An further instruction to the trustee to limit distributions to only those that supplement, but do not surplant, any government assistance available to the trustee, or words of a similar nature, should not be held to be an ascertainable standard.[5]

A power that is sometimes given to create grantor trust status is the power to add charitable beneficiaries to receive a portion of the trust remainder after the death of the special needs beneficiary. If given to an independent party, such as a trust protector, this power will create grantor trust status.[6]

Section 675 — Administrative Powers. If any person acting in a non-fiduciary capacity, without the consent of someone in a fiduciary capacity, has the power to reacquire the trust corpus by substituting other property of an equivalent value, the trust is a grantor trust.[7] If the grantor holds the power the trust would be a grantor trust. It also appears that such a power would not cause inclusion for estate tax purposes.[8] In Jordahl, the grantor held the power in a fiduciary capacity. The weight of authority finds that Jordahl would also apply in the case of a power held by the grantor in a non-fiduciary capacity.[9] However, there is still some risk that the power to reacquire assets could be a power that would cause inclusion in the estate of the grantor under Internal Revenue Code §§ 2036, 2039, or 2042. One could hypothesize circumstances in which the option to reacquire property, even at fair market value, would be a valuable option.

Note, however, the power may be held by any person acting in a non-fiduciary capacity without the consent of someone in a fiduciary capacity. So, it would seem that a person other than the grantor could hold such a power to avoid the potential argument for inclusion that would arise if the grantor held the power. Some commentators have expressed concern with the view, since the power is one to "reacquire" trust assets. It is not clear whether a person that never had the assets would ever be able to "reacquire" the assets. The Internal Revenue Service has indicated in several rulings that someone other than the grantor could acquire the assets. However, these rulings do not address the quandry

of a non-grantor's ability to "reacquire" assets that he or she never owned previously.[10]

It is possible that the Department of Health Services could assert that this power, held by the grantor who is also the special needs beneficiary (such as with a (d)(4)(A) SNT) could somehow cause the trust assets to become available resources. While the author believes that it is unlikely the Department of Health Services would prevail with such an argument, it seems that the better course of action would be to give this power to someone other than the grantor / beneficiary.

Section 676 — Power to Revoke. The power to revoke or amend a trust makes the trust a grantor trust. As the assets in a self-created revocable trust would be considered available for SSI eligibility purposes, revocable trusts are generally not used for Special Needs planning purposes.[11]

Section 677 — Income for Benefit of Grantor. If the income of the trust is used for the benefit of the grantor or the grantor's spouse or may be so used in the discretion of the grantor or a nonadverse party, or both, the trust is a grantor trust. However, this does not apply if the trust income may only be so applied with the consent of an adverse party. The IRS recently held that a (d)(4)(A) Trust was a grantor trust because the trustee had the discretion to distribute the income of the trust to the grantor / special needs beneficiary.[12]

D. Reimbursement of Grantor / Special Needs Beneficiary for Income Taxes Paid

Grantor trust status has some obvious and some less obvious implications. The grantor must pay the tax, which means of course that the trust need not pay the tax. Income from the trust is reported on the grantor's personal income tax return. When set up for estate tax planning reasons, this has the effect of allowing the assets in the trust to grow income-tax-free. Essentially, this is the equivalent of the grantor transferring the amount of the income tax to the trust without paying gift taxes. The grantor is not making a gift to the trust by paying the trust's income tax when the grantor has a legal obligation to do so and there is no right of reimbursement.[13]

This benefit is generally not applicable to Special Needs Trusts, as the grantor/disabled beneficiary does not usually have a taxable estate. Of even greater concern is the fact the disabled beneficiary may not have the funds available to pay the income tax for which he or she will be liable. For many years the question that remained unanswered was whether the Special Needs Trust could pay the income tax or reimburse the grantor without adverse income tax or estate tax consequences. That question was answered in 2004.

In Rev. Rul. 2004-64, 2004-27 I.R.B. 7 (July 1, 2004), the IRS addressed the issue of whether a grantor trust can pay the tax liability of the grantor. Previous to the Ruling, it had been feared that if the grantor trust paid the tax liability of the grantor that the grantor trust may lose its grantor trust status or that payment of the income tax would cause inclusion in the taxable estate of the grantor under Internal Revenue Code § 2036.

Rev. Rul. 2004-64 provided that there is no loss of grantor trust status or inclusion in the estate of the grantor where (a) neither state law nor the trust instrument itself contains any provision requiring or permitting the trustee to distribute to the grantor an amount sufficient to satisfy the grantor's income tax liability or (b) the trust instrument provides that the trustee *may*, in the trustee's discretion, distribute to the grantor trust income or trust principal sufficient to satisfy the grantor's tax liability. The IRS opined that should the trust instrument or state law require the trustee to distribute to the grantor income or trust principal in an amount sufficient to satisfy the grantor's income tax liability, the trust assets would be includible in the grantor's estate at death under Internal Revenue Code § 2036(a). This is because the grantor would have retained the right to have trust property expended to discharge his legal obligation.

Based on this Ruling, it appears that the prudent course of action in drafting a SNT that is intended to qualify for grantor trust status is to include a provision that the trustee may, in his or her discretion, pay for the benefit of the grantor, an amount from the trust income or principal sufficient to pay the grantor' federal and state income tax liability attributable to the SNT's income.

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II. Gift Tax and Estate Tax Issues

C. First Party Trusts

1. Gift Tax Issues

A gift is a transfer for property for less than full and adequate consideration. The transfer of property constitutes a completed gift to the extent that the donor has parted with dominion and control of the property.[14] In the case of the funding of a First Party Trust to hold litigation proceeds resulting from a negotiated settlement, it should be considered that there is no gift from the grantor to the trust because the amount received from the settlement is in exchange for a release of claim for consideration. Furthermore, the disabled grantor does not intend to make a gift because the First Party Trust is intended to be for the sole benefit of the disabled grantor. Finally, if the grantor retains a power over the disposition of the trust assets, such as a limited power of appointment at death, there would be no completed gift for gift tax purposes.[15]

With regard to a First Party Trust to hold an inheritance, the argument of a transfer for full and adequate consideration is not as great. However, it still can be argued that the disabled grantor does not intend to make a gift because the First Party Trust is intended to be for the sole benefit of the disabled grantor. In addition, if the SNT is drafted with a limited power of appointment in favor of the grantor, there would be no completed gift for gift tax purposes.

If the IRS were to successfully make an argument that there is a completed gift to the First Party Trust, it would be very difficult to value such gift. The SNT is intended to be for the sole benefit of the disabled grantor during the grantor's lifetime. Distributions from the SNT are at the sole discretion of the trustee, so the trustee could decide to distribute all the trust assets for the benefit of the disabled grantor during the grantor's lifetime, or very little of the trust assets. For some grantors, their disabilities may be such that it might be possible for an actuary to predict with reasonable accuracy the amount and timing of distributions. For other grantors, this may not be possible. For those situations where it is not possible to determine the value of the remainder interest, it would not be possible to value of the gift would be incapable of being valued.

2. Estate Tax Issues

The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for a period not ascertainable without reference to his death or for any period which does not in fact end before his death — (1) the possession and enjoyment of, or the right to the income from, the property . . ..[16]

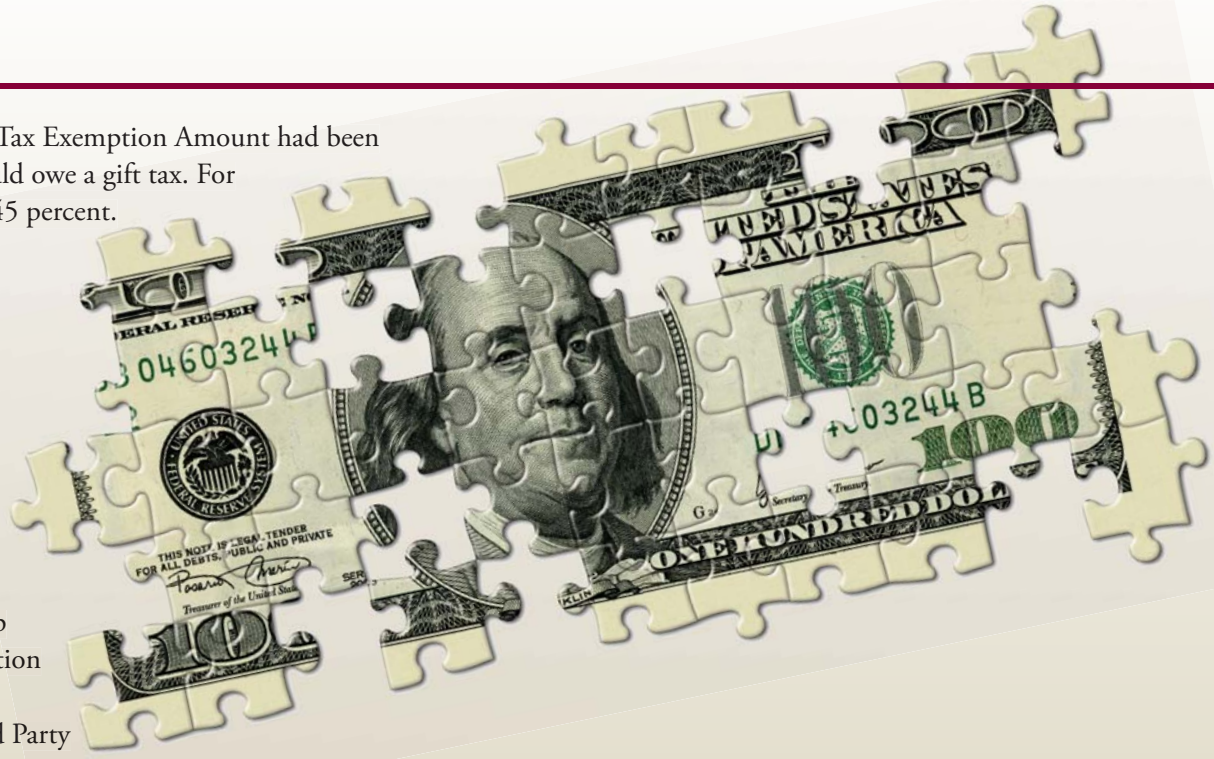
Given that the funds of (d)(4)(A) SNT are to be used for the sole benefit of the grantor during the grantor's lifetime, Section 2036 would pull the value of the trust assets back into the estate of the grantor for estate tax purposes.[17] The value of an estate that can be passed free of estate taxes in 2009 is $3.5 million. Given that the estates of most special needs persons, even with inclusion of the value of the SNT, will not exceed this,, estate taxes are generally not of great concern. Even if the value of the estate is over the exempt amount, the claim by the Department of Health Services for recovery against the value of the (d)(4)(A) SNT may bring the value of the estate below the exempt amount.

D. Third Party Trusts

1. Gift Tax Issues

The provisions of a SNT created by a third party grantor during his or her lifetime must be closely scrutinized to determine whether there is a gift for gift tax purposes. If the lifetime SNT is structured as a revocable trust, the gift would not be complete for gift tax purposes. As with the First Party SNT, if the grantor retains a power of appointment there is no completed gift for gift tax purposes.

If the Third Party SNT is irrevocable and the grantor retains no power of appointment, then it is likely a completed gift has occurred. A gift of a future interest does not qualify for the annual gift tax exclusion amount ($12,000 per donee per year in 2008).[18] As such, the grantor would have to file a Form 709 Gift Tax Return and apply a portion of his or her Lifetime Gift Tax Exemption Amount ($1,000,000 in 2008) to shelter the value of the gift to the SNT. To the extent the grantor has inadequate Lifetime Gift Tax Exemption Amount to fully shelter the gift to the Lifetime Third Party Special Needs Trust (either because the gift is more than $1 million or because the grantor has made other gifts previously to which some of the grantor's



$1 million Lifetime Gift Tax Exemption Amount had been applied), the grantor would owe a gift tax. For 2007, the gift tax rate is 45 percent.

In the case of a married couple, it is possible that they could split the gift, which would allow them both to use their respective Lifetime Gift Tax Exemption Amounts, for a total of $2 million.

Where a grantor is concerned about using up Lifetime Gift Tax Exemption Amount, it is possible to structure a Lifetime Third Party SNT to include "crummey powers."[19] A crummey power is a beneficiary withdrawal right that lapses within a relatively short time, usually 30 to 60 days. If the crummey power holder fails to withdraw the amount designated within that lapse period, the lapsed amount is forfeited and becomes a part of the Lifetime SNT trust estate. Because the beneficiary had the opportunity to withdraw the amount contributed, this creates a present gift as to such amount, and therefore eligible for the $12,000 per donee annual gift tax exemption amount.

Generally, a Third Party SNT structured in this manner does not contain a crummey withdrawal right for the special needs beneficiary. The Department of Health Services would assert the amount available to be withdrawn by the special needs beneficiary is an available asset that would potentially disqualify the beneficiary from public assistance. As such, crummey power holders should be limited to the remainder beneficiaries under the Third Party SNT. For a more in-depth discussion of crummey powers and how to draft an irrevocable trust containing crummey powers, see Drafting California Irrevocable Trusts (CEB 2006), §§ 12.80 – 12.110.

2. Estate Tax Issues

The question of whether a Third Party SNT will be included in the estate of the grantor depends on how the trust is drafted. If the Third Party SNT is created during the grantor's lifetime and is structured as a completed gift, the assets of the Third Party SNT will not be included in the grantor's estate at death (assuming that the grantor retained no beneficial interest under the trust which would pull the assets back into the grantor's estate under Internal Revenue Code §§ 2036, 2038 or 2042).

If the Third Party SNT was drafted as a revocable trust or the grantor retained a limited power of appointment over a trust that was otherwise irrevocable (in order to make the gift to the Third Party SNT incomplete for gift tax purposes), then the assets of the Third Party SNT will be included in the grantor's estate at death.

If the grantor's estate is less than $2 million ($4 million in the case of a married couple that properly structures their estate plan), then inclusion of assets of the Third Party SNT in the estate will not likely be a problem from a federal estate tax perspective. It would also have the added benefit of causing a step-up in basis for income tax purposes for the assets in the Third Party SNT. This will reduce income taxes if the SNT trust assets need to be sold after the grantor's death.

If the grantor has a taxable estate, several estate planning strategies can be used to reduce the amount of estate taxes due. These strategies can be combined with an Third Party

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SNT to not only reduce the amount of estate tax due, but also protect the assets for the special needs beneficiary. Some examples of such strategies include: (a) transferring a residence to a Qualified Personal Residence Trust ("QPRT") with the residence being paid to a Third Party SNT after the expiration of the QPRT term; (b) use of a Grantor Retained Annuity Trust, with the remainder being paid into a Third Party Special Needs Trust; and (c) combining the use of a Family Limited Partnership with a Defective Grantor Trust/ Third Party Special Needs Trust. These strategies are more thoroughly discussed in the author's article, Tax Efficient Funding of a Lifetime Special Needs Trust at page 32 of 32 Est. Planning J. 10 (Oct. 2005).

Footnotes

1 A nonadverse party is defined as any person that is not an adverse party (see definition of adverse party at fn 22 below). Treas. Reg. § 1.672(b)-1

2 An adverse party is defined as any person with a substantial beneficial interest (income or remainder) who would be adversely by the exercise or non-exercise of a power. Treas. Reg. § 1.674(a)-1

3 A limited or special power of appointment is a power of appointment where the potential appointees are limited to a class defined by the grantor of the power. The class can be defined very narrowly, such as descendants of the grantor, or very broadly, such as the power to appoint to any person other than the power holder, the power holder's estate, the creditors of the power holder or the creditors of the power holder's estate (the ability by the power holder to appoint to himself, to his estate or to the creditors of either would create a general power of appointment rather than a limited power of appointment).

4 Internal Revenue Code § 674(b)(3)

5 An ascertainable standard is defined in Internal Revenue Code § 2041(b)(1)(A) as a distribution for the health, education, maintenance or support of the beneficiary.

6 *Madorin v. Comm'r,* 84 T.C. 667 (1985); PLR 199936031; PLR 9709001

7 Internal Revenue Code § 675(3)(c)

8 *Estate of Jordahl v. Comm'r,* 65 T.C. 92 (1975)

9 PLR 200001015; PLR 200001013; PLR 199922007; PLR 9642039.

10 PLR 199908002; PLR 9810019; PLR 9713017

11 An exception might be where a parent or grandparent creates a stand-alone, lifetime third party SNT that is not anticipated to receive contributions from any other party and where there are gift tax or estate tax reasons that mandate the use of an irrevocable trust.

12 PLR 200620025

13 *Comm'r v. Hogel,* 165 F.2d 352 (10th Cir. 1947); Comm'r v. Beck, 129 F.2d 243 (2d Cir. 1941).

14 Treasury Regulation § 25.2511-2(b)

15 Treasury Regulation § 25.2511-2(c)

16 Internal Revenue Code § 2036(a)

17 PLR 9437034

18 See *Drafting California Irrevocable Trusts* (CEB 2006) § 12.80 for more information.

19 See *Crummey v. Comm'r,* 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 C.B. 321. Also see Estate of Cristofani v. Comm'r., 97 T.C. 74 (1991), AOD 1996-010