The Health & Education Exclusion Trust (HEET)

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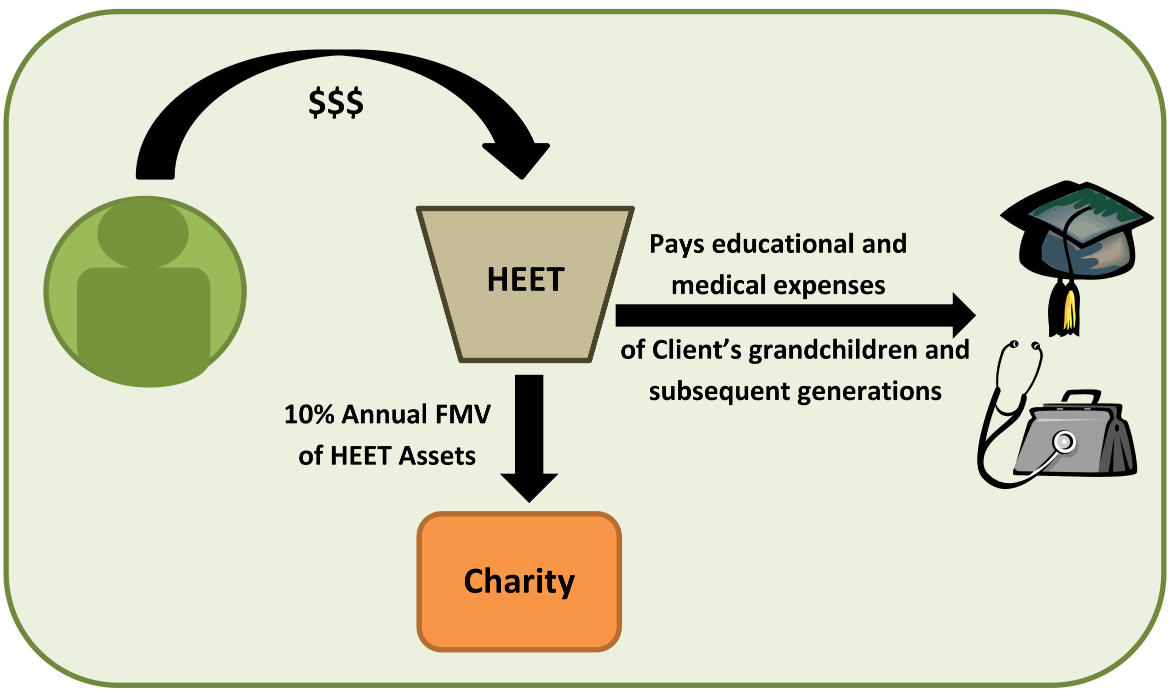
The Obama Administration's new fiscal year budget repeats several proposals targeting and eliminating the future use of tax and estate planning techniques. This article discusses one targeted technique, the Health and Education Exclusion Trust ("HEET"). Further, Obama proposes to significantly lower and freeze the current unified gift and estate tax exclusion amount of $5.34 million per person to an estate tax exclusion of $3.5 million and the gift tax exclusion of $1 million (i.e., 2009 levels) effective in 2018.

What is a HEET?

A HEET technically speaking is a trust that lasts for multiple decades which the client uses to pay medical and educational expenses of the client's grandchildren, great grandchildren and subsequent generations. One of the beneficiaries to the HEET is a charity that has a "substantial present economic interest" for purposes of the tax Code. The charity-beneficiary ensures that the transfer to the HEET is not a direct skip for GST tax purposes, while the distribution standard requiring payment only directly to educational and medical institutions avoids gift taxes. Thus, HEETs create tax-efficient transfers where GST and gift taxes would usually apply.



When Does the Use of a HEET Make Sense?

In general, a HEET only makes sense for clients with a certain amount of wealth. A HEET is an irrevocable trust in which the client will permanently be unable to use the assets that the client transfers to the HEET. Thus, the client needs to have substantial assets besides those transferred to support the client for the remainder of his or her life.

A HEET also only makes sense for clients that have or anticipate having grandchildren or great grandchildren (or non-family members of similar age to these younger generations) that they wish to provide financial support to for medical and educational purposes. The client needs to also be somewhat charitably-inclined because one of the benefits and burdens of the HEET is that a charitable beneficiary selected by the client must receive at least 10% of the annual fair market value of the HEET's assets. The client may even choose to make the client's own private foundation the charitable beneficiary, making the HEET and even more attractive option.

What Tax-Exempt Transfer Techniques do HEETs Utilize?

A donative transfer from the client to their grandchildren, great grandchildren or subsequent generations (or non-family members of similar age to these younger generations) may be subject to gift and generation skipping ("GST") taxes. These taxes can significantly reduce the amount the beneficiary actually receives.

However, HEETs utilize two types of transfers that are exempt from GST and gift taxes:

1. Under the tax Code, if the client makes a transfer directly to an educational institution or medical care provider to pay the expense incurred by someone other than the client then the transfer is not subject to gift or GST taxes. IRC Sections 2503(e) and 2611(b)(1).

2. A transfer made to a trust in which all beneficiaries are two generations below the client for purposes of the IRC (i.e., "skip persons") is a "direct skip" which is subject to a 40% GST tax. However, a transfer to a HEET has a non-skip beneficiary (the charity) and is thus not subject to the 40% GST tax.

Thus, a HEET effectively pays off the educational and medical expenses of grandchildren and subsequent generations in a manner that avoids significant gift and GST taxes.

What are the Common Ways HEETs are Created/Funded?

HEETS may be created by Will but the assets transferred to the HEET will be included in the client's estate and possibly subject to estate tax. Thus, it is often most effective to form a HEET during the client's life to push all future appreciation in the HEET assets out of the client's estate. The client may fund the HEET through use of annual exclusion gifts, use of the lifetime gift exclusion, by an irrevocable life insurance trust ("ILIT") drafted as a HEET, or through the use of a grantor retained annuity trust with a HEET as the beneficiary.

What are the Essential Elements of a HEET?

1. The HEET must be established in a state that allows for perpetual trusts. California allows a trust to remain in existence for 90 years before it must distribute its assets. While a few other states have longer periods or allow for a trust to exist in perpetuity, the Obama Administration has proposed limiting all states to a 90 year perpetuity period.

2. To avoid GST taxes, the trustee of the HEET must only make qualified transfers to the non-charitable beneficiaries within the meaning of the IRC exclusion provisions relating to payment of educational and medical expenses directly to those institutions.

3. The trustee of the HEET should have absolute discretion as to distribution to non-charitable beneficiaries so as to maximize creditor protection. Further, because of the perpetual nature of the HEET, the client should name an independent trustee or co-trustee to provide some stability in administration decades after the client establishes the HEET.

4. As mentioned before, the charitable beneficiary's interest must be significant or else the HEET will no longer be exempt from GST tax.

How Does the Obama Administration Plan to Change HEETs?

Code Section 2611(b)(1) states: "The term 'generation-skipping transfer' does not include—(1) any transfer which, if made inter vivos by an individual, would not be treated as a taxable gift by reason of section 2503(e) (relating to exclusion of certain transfers for educational or medical expenses)." The Administration proposes to clarify this exclusion definition under Code Sec. 2611(b)(1) to ensure that donors are no longer able to use HEETs to avoid the GST tax. The Administration would accomplish this by altering the IRC to subject transfers to the substantial GST tax either upon funding the HEET or upon distribution from the HEET for the benefit of non-charitable beneficiaries.