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The Care and Feeding of a HEET

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What is a HEET?

"HEET" is an acronym for a Health and Education Exclusion Trust. Health and Education Exclusion Trusts or "HEETs" are not new. The term HEET goes back at least as far as a *Trusts and Estates* magazine article in 2000 which used the term HEET.[2]

As explained more fully below, HEETs provide donors with a way to provide for the medical and tuition expenses of "skip people" without utilizing any of the donor's Generation-Skipping Transfer Tax exemption amount. This is accomplished by creating and funding a trust that is not a skip person trust or a skip trust (i.e., creating and funding a trust that has at least one non-skip person or a charity(ies) as a current beneficiary).

HEETs are not commonly used estate planning tools, but in the right circumstances and properly used, a HEET can be a very effective way to provide for the health and education of lower generations while supporting charities.

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[2] Roy M. Adams, David A. Handler, and Deborah V. Dunn, *A New Twist on Sec. 2503(e): Health and Education Exclusion Trust (HEET)*, TRUSTS & ESTATES MAGAZINE, Vol 139 (July 2000), at page 18.

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Disclaimers

Instead of putting them in a footnote at the end, I'll start with some Disclaimers.

This presentation is intended to be a general overview. No one will walk away from this presentation as an expert on HEETs. Hopefully this presentation will be new information that piques the interest of some or is a good review for others.

This presentation only addresses federal taxes. It does not address any state taxes – but keep state taxes in mind when you think about, draft, or make distributions from any trust including a HEET.

When do HEETs make sense?

HEETs make sense for a taxpayer who has used all of his/her/their Generation Skipping Transfer ("GST") tax exemption and wants to make additional gifts to skip people or wants to use his/her/their GST exemption on other gifts. A donor in either situation who wants to assist lower generations with health and tuition expenses, as well as benefiting charitable entities may accomplish these goals with a HEET.

HEET Review

What is a HEET?

- As mentioned above, a HEET is a trust that has at least one non-skip person beneficiary, which is a charity, and also has skip people as beneficiaries.
- For the skip person beneficiaries, a HEET allows for distributions for qualified tuition and medical expenses without subjecting those distributions, or the trust itself, to the GST taxes.
- For charitable beneficiaries, a HEET can be a long-term funding source.

Why is there no Generation-Skipping Transfer tax on a gift to a HEET or on distributions for a skip person's tuition or medical expenses?

- Usually, a gift into a trust for the benefit of skip persons is a direct skip under Internal Revenue Code ("IRC") sections 2611(a), which defines a generation-skipping transfer[3]

[3] **26 U.S. Code § 2611** - Generation-skipping transfer defined - (a) In general **…** the term "generation-skipping transfer" means— (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

and 2613(a), which defines a skip person and a skip trust.[4] A gift to such a trust is usually subject to GST tax.

- But, a trust isn't a skip person unless **all** of the beneficiaries of the trust are skip people under IRC 2613(a).

- Charities are not skip people per IRC 2613, which says a skip person must be a natural person or a trust with all of the interests held by skip persons. Additionally, under IRC section 2651(f)(3), which described generation assignments, says any entity described in IRC section 511(a)(2) and IRC section 511(b)(2)[5] is assigned to the transferor's generation.

- So, the gift into the trust with a charitable beneficiary is not a direct skip. Hence GST Tax does not apply to the gift into the trust.

What about GST tax on distributions?

- A GST taxable distribution is a distribution from a trust to a skip person.[6]

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[4] **26 U.S. Code § 2613** - Skip person and non-skip person defined - (a) Skip person -For purposes of this chapter, the term "skip person" means— (1) a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor, or (2) a trust— (A) if all interests in such trust are held by skip persons, or (B) if— (i) there is no person holding an interest in such trust, and (ii) at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person.

[5] **26 U.S. Code § 511** - Imposition of tax on unrelated business income of charitable, etc., organizations- . . .
(a)(2)(A) Organizations described in sections 401(a) and 501(c) - The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501(c)(1)) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a).

(a)(2)(B) State colleges and universities
The tax imposed by paragraph (1) shall apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions. Such tax shall also apply in the case of any corporation wholly owned by one or more such colleges or universities.

(b)(2)(B) State colleges and universities
The tax imposed by paragraph (1) shall apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions. Such tax shall also apply in the case of any corporation wholly owned by one or more such colleges or universities.

[6] **26 U.S. Code § 2612** - Taxable termination; taxable distribution; direct skip - . . . (b)Taxable distribution
For purposes of this chapter, the term "taxable distribution" means any distribution from a trust to a skip person (other than a taxable termination or a direct skip).

- So, why aren't distributions for a skip person's tuition or medical expenses GST taxable distributions?

    - Because IRC section 2611(b) states, "the term generation-skipping transfer does not include any transfer which, if made by an individual, would not be treated as a taxable gift by reason of IRC section 2503(e).

    - IRC section 2503(e) specifically states that certain transfers for tuition at qualified educational organizations or to pay for medical care is excluded from the definition of a taxable gift.[7]

- The Treasury Regulations help define what tuition and medical expenses that can be paid by a HEET.
    - **§ 25.2503-6 Exclusion for certain qualified transfer for tuition or medical expenses.**
        - **(a)** ***In general.*** Section 2503(e) provides that any qualified transfer after December 31, 1981, shall not be treated as a transfer of property by gift for purposes of Chapter 12 of Subtitle B of the Code. . . . A contribution to an ABLE account established under section 529A is not a qualified transfer.
        - **(b)** ***Qualified transfers*** -
        - **(1)** ***Definition.*** For purposes of this paragraph, the term "qualified transfer" means any amount paid on behalf of an individual[8] -
            - **(i)** As tuition to a qualifying educational organization for the education or training of that individual, or
            - **(ii)** To any person who provides medical care with respect to that individual as payment for the qualifying medical expenses arising from such medical care.

        - **(2)** ***Tuition expenses.*** For purposes of paragraph (b)(1)(i) of this section, a qualifying educational organization is one which normally

[7] **26 U.S. Code § 2503** - Taxable gifts - . . . (e)Exclusion for certain transfers for educational expenses or medical expenses - (1) In general [a]ny qualified transfer shall not be treated as a transfer of property by gift for purposes of this chapter. (2)Qualified transfer [f]or purposes of this subsection, the term "qualified transfer" means any amount paid on behalf of an individual— (A) as tuition to an educational organization described in section 170(b)(1)(A)(ii) for the education or training of such individual, or (B) to any person who provides medical care (as defined in section 213(d)) with respect to such individual as payment for such medical care.

[8] Please note – the payment must be "*paid on behalf of an individual*." The payment cannot be made to the individual. The payment must be made directly to the provider of medical care or the educational institution. A distribution made to the individual and then used by the individual to pay for his/her/their tuition or medical expenses does not qualify as a non-gift transfer under IRC 2503(e). Hence it would be GST taxable distribution subject to GST tax under IRC sections 2601, 2611, and 2612(b).

maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. See section 170(b)(1)(A)(ii) and the regulations thereunder. The unlimited exclusion is permitted for tuition expenses of full-time or part-time students paid directly to the qualifying educational organization providing the education. No unlimited exclusion is permitted for amounts paid for books, supplies, dormitory fees, board, or other similar expenses which do not constitute direct tuition costs.

- **(3)** ***Medical expenses.*** For purposes of paragraph (b)(1)(ii) of this section, qualifying medical expenses are limited to those expenses defined in section 213(d) (section 213(e) prior to January 1, 1984) and include expenses incurred for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body or for transportation primarily for and essential to medical care. In addition, the unlimited exclusion from the gift tax includes amounts paid for medical insurance on behalf of any individual. The unlimited exclusion from the gift tax does not apply to amounts paid for medical care that are reimbursed by the donee's insurance. Thus, if payment for a medical expense is reimbursed by the donee's insurance company, the donor's payment for that expense, to the extent of the reimbursed amount, is not eligible for the unlimited exclusion from the gift tax and the gift is treated as having been made on the date the reimbursement is received by the donee.

- **What is qualifies and an "Educational Organization" under IRC 2503?**
  - The term ***section 170(b)(1)(A) organization*** as used in the regulations under section 170 an organization whose primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities. It includes Federal, State, and other public-supported schools which otherwise come within the definition. It does not include organizations engaged in both educational and noneducational activities unless the latter are merely incidental to the educational activities. A recognized university which incidentally operates a museum or sponsors concerts is an educational organization within the meaning of section 170(b)(1)(A)(ii). However, the operation of a school by a museum does not necessarily qualify the

museum as an educational organization within the meaning of this subparagraph.

Drafting Issues Related to a HEET

The following are some of the things to be considered in drafting a HEET:[9]

- **Beneficiaries –** Generally speaking, a HEET is for the benefit of individuals who are more than one generation below the grantor/transferor as well as at least one charitable entity.

  - There is no reason that a HEET cannot also benefit people who are not skip persons (e.g., the grantor's children or spouse). People of the same generation as the donor or one generation below the grantor can be beneficiaries of a HEET. However, HEETs are usually designed to benefit people more than one generation below the grantor of the HEET.

  - To ensure that the trust does not have a GST tax event when all of the non-skip individuals cease to be trust beneficiaries[10], an entity that cannot die is included as a beneficiary of the HEET. That is why the HEET should have a charitable beneficiary(ies).

- **Situs** – How long does the grantor want the trust to last? Make sure the trust's situs allows for that period of time.

- **Grantor vs Non-Grantor –**
  - Grantor - If the trust is a grantor trust under IRC sections 671 -679, the beneficiaries will not have to pay income tax on the trust distributions made on their behalf. The grantor will to bear the tax burden on the trust's taxable income. The grantor may also take a charitable deduction related to the distributions to charity. Such a deduction will be subject to all the regular charitable deduction rules applicable to the grantor.

  - Non-Grantor – Distributions for the beneficiaries' tuition or medical expenses can carry out Distributable Net Income ("DNI") under IRC section 662 to those beneficiaries. Those beneficiaries will need to pay the income tax related to such distributions. If the HEET makes a distribution to pay the income tax, that will be a GST taxable distribution under IRC section 2612, and the beneficiary will bear

[9] This is only a sampling of the issues to be considered as part of the overall design of the HEET.

[10] If the non-skip person beneficiaries of the trust all die or otherwise cease to be trust beneficiaries, the trust has a "taxable termination" under IRC section 2612.

the GST tax in addition to the income tax[11]. But, the trust can take a full charitable deduction under IRC section 642 for its distributions to the charity(ies).

- **Inter Vivos vs Testamentary** – HEETs are often an inter vivos trusts. But, they can also be testamentary trusts. However, there is no estate tax charitable deduction for a HEET and the trust will be a Non-Grantor Trust.

- **The Charity's Interest –**
  - Ensure that there is language in the HEET that allows for the appointment of a successor charitable beneficiary(ies). If the charitable entity ceases to be a charitable entity, that is the equivalent of a GST Taxable Termination, with the trust being liable for paying the GST tax on the termination. So, the trust should have a provision to prevent that from happening.

  - Make sure that the charity has a current right to some income and a discretionary right to principal, but do not spell out the right to principal. If the charity's interest can be carved out of the trust or the trust can be bifurcated into a share for the benefit of the charity and a share for the benefit of the skip persons, the IRS could argue the charity has its own separate trust. Thus, the HEET could be characterized two separate trusts, as one trust for the benefit of the charity and one trust for the benefit of the skip people.

  - Make sure the charity's interest does not terminate before the trust terminates and as mentioned above, allow for a mechanism to ensure a charitable beneficiary is always a beneficiary of the trust.

  - Ensure that the charity has a right to some non- di minimis portion of the trust's income each year. Often practitioners suggest at least 10% of the HEET's income be distributed to the charitable beneficiary. But, for the reasons discussed above, do not give the charity any right to principal.

  - Consider IRC section 663 and the associated Treasury Regulations, which contain the separate share rules. Giving a specific income interest to the charity, along with additional discretionary income distributions and unascertainable principal distributions in the trustee's sole discretion, such that distributions of income, accumulated income, or principal to any beneficiary affects the amount of income, accumulated income, or principal available to the other beneficiaries should help get past the separate share rules.[12]

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[11] **26 U.S. Code § 2603** - Liability for tax - (a) Personal liability (1)Taxable distributions - In the case of a taxable distribution, the tax imposed by section 2601 shall be paid by the transferee.

[12] See Treasury Regulation 1.663(c)-3(b).

- IRC section 2652(c) describes the sort of interest a trust beneficiary must have in the trust for GST purposes. A beneficiary (either individual or charity) that does not have an interest described in 2652(c) or whose interest in the trust is "used primarily to postpone or avoid" the GST tax shall be disregarded (not be a treated as a skip person).

Caring for a HEET
(or issues for the HEET Trustee to consider)

Here are some of the things that the trustee should carefully consider when administering a HEET:

The trustee should:

- Confirm that any distributions be paid directly to educational institutions and medical providers qualify as non-taxable transfers under IRC section 2503 and the regulations thereunder.

- Determine whether distributions for a beneficiary's medical needs is superior to distributions for a beneficiary's tuition (i.e., is the trust primarily for the payment of qualified tuition or for the payment of qualified medical expenses).

- Consider the length of time the trust may be in existence when making distribution decisions. In Washington a trust can last for 150 years from the time it was created. In Oregon it can be 90 years (or life in being plus 21 years). If a generation is 30 years, there may be 3 to 5 generations beyond those who were alive when the trust was created.

- While it can be very difficult, the trustee must balance the needs of the current beneficiaries against the needs of the future beneficiaries and the size of the trust when deciding on how much to distribute each year. This is especially true because the inflation rate for tuition and medical expenses can outpace general inflation. – Has the Grantor given any direction to the trustee?

- Keep trust expenses, including taxes, in mind when deciding on distribution amounts. Remember, the trust is a complex trust and is subject to tax on its undistributed income and its net capital gains.

- Get a list of all beneficiaries each year to help forecast distribution amounts. This will help the trustee to know if any beneficiaries have been born or died. For tuition distributions, forecast beneficiary needs by year.

- Decide on any qualifications and academic success thresholds for a beneficiary to be eligible to receive tuition payment.

- Decide whether the distributions for tuition or medical expenses will have a "need" based component.

- Determine whether the student must be a full-time student to receive distributions for tuition.

- Determine if skipping a year (or more) of school invalidates a beneficiary from receiving tuition distributions.

- Determine whether a conflict of interest arises when a trustee's relative or trust advisor's relative applies for a trust distribution and if so how to address the conflict. In such a case, have a written methodology to determine when to make distributions.

- Determine what tuition distributions will be made (e.g., primary or secondary private schools, college, and /or graduate and post-graduate education).

- Determine whether to limit the cumulative lifetime distributions payable for the benefit of a single beneficiary.

- Determine whether to allow variances from the general trust policies for beneficiaries with special needs and/or for descendants who have demonstrated extraordinary success or other circumstances.

- Determine whether a policy to scale or limit the distributions tied to the value of the trust assets is appropriate.

- Determine whether to establish maximum annual or lifetime distribution total per family line and/or to allocate the funds for each year among family applicants.

- Remember – the payment of a beneficiary's health insurance qualifies as a medical expense under IRC 2503(e) under Reg 25.2503-6(a)(3).

- Annually, determine if the distribution to charity will exceed any specified amount required by the trust document (i.e., whether any discretionary income or principal payment will be made to charity). This determination should be made each year without regard to such distributions in prior years.

Income tax considerations: Who is the transfer to, the child or the parent? Why/when does that matter?

- As mentioned above, distributions may carry taxable income out with them in the form of Distributable Net Income pursuant to IRC section 643. How will the income tax be paid?
- Does the "kiddie tax" apply?
- Distributions from the trust to the beneficiary for taxes creates a GST taxable distribution and additional income.
- If the trust is an Electing Small Business Trust under IRC section 1361(e), the trust will pay the income tax on all S-corporation income, unless it is a grantor trust.

Additional issues related to non-2503(e) distributions:

- The trustee might be in breach of his/her/its fiduciary duty, depending on the terms of the trust.
- GST will be due and will be paid by the beneficiary.

Trustee Investment Considerations:

- Investments should be made to produce income to satisfy charitable interest. A failure to produce income could cause the charitable interest to be deemed as illusory by the IRS.
- Periodic distributions of principal can help ensure charitable interest isn't disregarded.
- Depending on the definition of principal and income for the trust, investing to produce capital gain may reduce distributable net income. As a result, a beneficiary may have less taxable income when distributions are made.

Feeding the HEET

Considerations in the "feeding" of a HEET or funding the HEET:

As mentioned above, a properly drafted and administered HEET gives a donor a way to benefit skip people without triggering the Generation-Skipping Transfer tax. However, all of the usual issues related to funding a trust continue to apply. In other words, funding the trust can still be subject to gift (or estate) taxes.

However, there may be a way to fund an inter vivos HEET that is not subject to gift taxes by using a "zeroed out" Grantor Retained Annuity Trust or ("GRAT")[13].

Generally speaking, GRATs are not used to make transfers to, or for the benefit of, skip persons.

- Under IRC 2632 and Reg. 26.2632-1, a taxpayer cannot effectively allocate GST exemption to a trust during an Estate Tax Inclusion Period ("ETIP").14 A GST allocation is only effective at the end of the ETIP.
- Due to the uncertainty in the value of the remainder interest in a GRAT, the taxpayer cannot know how much the GST tax may be attributable to a GRAT, until the GRAT has terminated and is no longer within an ETIP. This is why GRATs generally do not have skip persons as remainder beneficiaries.
- A properly drafted and administered HEET is not a skip person or a skip trust. Hence, GST tax does not apply to GRATs.
- So, the issues related to effectively allocating GST exemption or calculating the GST tax related to the remainder interest in a GRAT do not apply when the remainder interest in a GRAT is a HEET.
- If the taxpayer establishes a GRAT with a HEET as the remainder beneficiary, the taxpayer can use a GRAT to benefit skip people.
- If the GRAT is "zeroed out" and is successful (i.e., there is a remainder after the GRAT term), then a taxpayer may benefit skip person beneficiaries without any gift tax (because the GRAT is "zeroed out" and without any GST taxes (because the remainder beneficiary is a HEET).

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[13] A discussion of Grantor Retained Annuity Trusts or "GRATs" is beyond the scope of this presentation. GRATs are estate planning tools that are statutorily sanctioned under IRC Section 2702. Prior to exploring how a GRAT, or series of GRATs, might work with a HEET, it is important to thoroughly understand GRATs.

[14] **§ 26.2632-1(c)(2)** - *Estate tax inclusion period defined*—(i) *In general.* An ETIP is the period during which, should death occur, the value of transferred property would be includible (other than by reason of section 2035) in the gross estate of— (A) The transferor; or (B) The spouse of the transferor. [*see 26.2632-1(c)(2) for exceptions to the general ETIP rules*].

Summary

The best way to summarize is to circle back to what is mentioned at the very beginning of this presentation – a HEET is not a commonly used estate planning tool, but it can be a highly effective way to provide for part of a skip person's educational expenses and provide support for charitable entities. This may be especially true when a HEET is paired with a GRAT or series of GRATs. It can be win – win – win. It is a "win" by assisting lower generations with education or medical expenses. It is a "win" for the charitable beneficiary, and it is a "win" for the donor who wants to benefit lower generations and charitable entities at a very low transfer tax cost.

More Disclaimers:

THE DEVIL IS IN THE DETAILS: The tax issues and concepts described in this presentation are current as of August 28, 2023. However, tax laws can and do change frequently. Additionally, court cases and Internal Revenue Service rulings and guidance are issued regularly. For these reasons, and many more, it is important that anyone considering the use of a HEET, or a GRAT, or a GRAT with a HEET as remainder beneficiary, consult with a tax advisor very familiar these things before making any decisions or taking any actions related to HEETs or GRATs (or any other tax planning for that matter).

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