Avoiding the Transfer for Value Rule
Quadpartite Will Redux
Lifetime Funding of Reverse QTIP Trusts
Tax-Efficient Funding of a Lifetime Special Needs Trust

As this article explains, numerous strategies are available to taxpayers with potential estate tax liabilities who wish to fund a special needs trust for a disabled beneficiary in a gift and/or estate tax-efficient manner.

DENNIS M. SANDOVAL, ATTORNEY

Planning for the needs of a disabled beneficiary can be problematic, especially if the beneficiary is receiving public assistance such as Medicaid, Supplemental Security Income (“SSI”), In Home Supportive Services, or Section 8 Housing. Lifetime gifts to the beneficiary may diminish the amount of public assistance available to the beneficiary or may even cause the beneficiary to lose eligibility for such assistance. An outright inheritance may also be considered an available asset to the disabled beneficiary, resulting in a reduction or loss of benefits.

To avoid these undesirable results, parents, grandparents, and other interested parties often establish lifetime or testamentary “special needs trusts” (also sometimes referred to as “supplemental needs trusts” or “SNTs”) for the disabled beneficiary. Because the lifetime or testamentary SNT is created by a third party and distributions for the benefit of the disabled beneficiary from the third-party SNT are at the discretion of the trustee, the trust’s assets are not counted as available assets for purposes of determining the disabled beneficiary’s eligibility for government assistance.

Because contributions to an SNT are gifts of a future interest that do not qualify for the gift tax annual exclusion, a parent who wishes to create a lifetime SNT must use part of his or her lifetime $1 million gift tax exemption amount to shelter the gift. For a parent who has already used much of the lifetime gift tax exemption to shelter gifts to other beneficiaries or as a part of various other estate planning strategies, a tax-efficient method of funding a lifetime SNT can be very helpful. There are various strategies that can accomplish tax-efficient funding of a lifetime SNT.

Combining QPRT with SNT

One strategy involves the use of a qualified personal residence trust or “QPRT,” which provides for funding of the residence into a third-party SNT upon the expiration of the QPRT term. With a QPRT, the grantor transfers her residence to a trust and retains the right to continue to live in the residence for a fixed term. Upon expiration of this right of occupancy, the grantor either can pay fair market rent to the SNT created under the QPRT or “vacate” the residence in favor of purchasing or leasing another residence. Because of the retained inter-
est, the value of the residence will be included in the grantor’s estate if she dies within the QPRT term. Consequently, the right of occupancy should be for a period less than the anticipated life expectancy of the grantor.

Because of the retained right of occupancy, the value of the gift to the residence to a QPRT can be substantially discounted from the fair market value (“FMV”) of the residence. For instance, assume that a 55-year-old grantor transfers a $500,000 residence to a QPRT, and retains the right to occupy the property until age 70. In this case, the value of the gift is $214,685.12 If the residence appreciates 5% annually during the term of the QPRT, it would actually be worth $1,039,464 at the end of the QPRT term.

Upon the expiration of the right of occupancy, title to the residence will be transferred to the SNT. Should the grantor decide to continue to occupy the property, she would pay FMV rent to the SNT, which will increase its ultimate value. Because the rent payments are required under the Internal Revenue Code, these payments would not be treated as additional gifts by the grantor.

Alternatively, at the end of the QPRT term, the grantor can move out of the property and the disabled beneficiary can then occupy the property as his residence. In this circumstance, the disabled beneficiary’s SSI benefits would be reduced under the presumed maximum value (“PMV”) rule. Under this rule, the value of the in-kind support and maintenance (“ISM”) is calculated as the lesser of: (1) its actual value, or (2) its PMV, which is one-third of the maximum monthly SSI payment plus $20. In this circumstance, there would need to be sufficient other assets in the SNT to cover the real property taxes and maintenance on the residence (and mortgage payments, if the property were financed). Finally, the residence could be sold and the proceeds from sale (after payment of capital gain taxes), could be reinvested for the benefit of the special needs beneficiary and distributed pursuant to the terms of the SNT, as illustrated in Exhibit 1.

Combining GRAT with SNT

A grantor retained annuity trust ("GRAT") is another form of split-interest trust. Under this approach, the grantor contributes assets to the GRAT in exchange for a stream of annuity payments that are calculated using the Section 7520 rate. Upon the expiration of the annuity payments, any excess assets in the trust pass to the remainder beneficiaries under the GRAT. As in the case of the QPRT, the value of the gift to the GRAT is reduced by the value of the retained interest under the IRS

---

1 Eligibility for these types of government assistance generally requires that the recipient have countable resources of $2,000 or less and income below certain designated levels. See 42 U.S.C. §§ 1382a and 1382b.
2 See Kruse, Jr., Third-Party and Self-Created Trusts: Planning for the Elderly and Disabled Client (3d ed. ABA, 2002).
3 There are two types of SNTs—third-party SNTs are those that are funded with the assets of a third party, either during the lifetime of the third party or as part of the third party’s testamentary scheme. The other type of SNT is a first-party SNT, which is funded with the disabled beneficiary’s own assets, such as a personal injury award or an outright inheritance. The structure of a first-party SNT is governed by the provisions of 42 U.S.C. §§ 1396p(d)(4)(A) and 1396p(d)(4)(C).
4 The Restatement (Second) of Trusts, § 155 cmt. b; Bogert, Bogert, and Hess, The Law of Trusts and Trustees, § 228 (rev. 2d ed. West, 1992 and Supp. 2001); Scott and Fratcher, Scott on Trusts, § 155 (4th ed. Little, Brown & Co., 1987), provide that it is the absolute discretion of the trustee as to whether or not to make distributions and the inability of the beneficiary to compel a distribution that creates the asset protection of a discretionary trust. While this protection is much greater than that offered by a traditional spendthrift trust, it comes at the price of leaving the beneficiary at the mercy of the trustee’s judgment to withhold or distribute trust income and principal.
5 See Reg. 25.2503-3.
6 See Section 2505(a).
7 There would be generation-skipping issues with the following strategies if a transfer is to a skip person.
8 The lifetime SNT can be an irrevocable stand-alone trust that can also be used for other strategies, or it can be incorporated into the QPRT document itself.
9 See Section 2036.
11 Reg. 25.2512-5(d)(2).
12 Assumes a Section 7520 rate of 4.2%.
13 POMS SI 00835.00C.1.
14 The maximum SSI payment for 2005 is $579. Therefore, the PMV for 2005 would be $213.
15 The QPRT’s basis in the residence would equal the donor’s basis in the residence. Section 1015(a).
EXHIBIT 1
Qualified Personal Residence Trust

<table>
<thead>
<tr>
<th>Year</th>
<th>Initial SNT Value*</th>
<th>Cumulative Distributions from SNT**</th>
<th>Ending SNT Value***</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$921,044</td>
<td>$25,000</td>
<td>$844,466</td>
</tr>
<tr>
<td>5</td>
<td></td>
<td>138,141</td>
<td>927,520</td>
</tr>
<tr>
<td>10</td>
<td></td>
<td>314,447</td>
<td>1,021,843</td>
</tr>
<tr>
<td>15</td>
<td></td>
<td>539,464</td>
<td>1,091,513</td>
</tr>
<tr>
<td>20</td>
<td></td>
<td>826,649</td>
<td>1,113,839</td>
</tr>
<tr>
<td>25</td>
<td></td>
<td>1,193,177</td>
<td>1,054,884</td>
</tr>
<tr>
<td>30</td>
<td></td>
<td>1,660,971</td>
<td>864,807</td>
</tr>
</tbody>
</table>

* Assumes sales price of $1,039,464, a basis of $250,000, and a capital gain rate of 15%.
** Assumes discretionary distributions by the trustee starting at $25,000 for year 1, and increasing the amount of the distribution by 5% each year thereafter.
*** Assumes 5% annual growth on the investment portfolio, reduced by annual distributions and federal/state combined ordinary and capital gain taxes at a blended rate of 30%.

EXHIBIT 2
GRAT—Fixed Annuity

<table>
<thead>
<tr>
<th>Year</th>
<th>GRAT Principal at Beginning of Year</th>
<th>Growth at 8% Annually</th>
<th>Annuity Payment Back to Grantor</th>
<th>Remainder Paid to SNT in Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,000,000</td>
<td>$80,000</td>
<td>$124,522</td>
<td>$955,478</td>
</tr>
<tr>
<td>2</td>
<td>955,478</td>
<td>76,438</td>
<td>124,522</td>
<td>907,394</td>
</tr>
<tr>
<td>4</td>
<td>855,463</td>
<td>68,437</td>
<td>124,522</td>
<td>799,378</td>
</tr>
<tr>
<td>6</td>
<td>738,807</td>
<td>59,105</td>
<td>124,522</td>
<td>673,889</td>
</tr>
<tr>
<td>8</td>
<td>602,738</td>
<td>48,219</td>
<td>124,522</td>
<td>526,435</td>
</tr>
<tr>
<td>10</td>
<td>444,028</td>
<td>35,522</td>
<td>124,522</td>
<td>355,028</td>
</tr>
<tr>
<td>Summary</td>
<td>$600,249</td>
<td>$1,245,220</td>
<td>$355,028</td>
<td></td>
</tr>
</tbody>
</table>

10 Under Walton, the value of the retained interest can be equal to the value of the assets contributed, thereby “zeroing out” the value of the assets contributed to the GRAT for gift tax purposes.

Upon the expiration of the annuity term, title to the remainder of the GRAT is transferred to the SNT, which can be either an irrevocable stand-alone trust or simply incorporated into the terms of the GRAT instrument. The trustee of the SNT would then hold the trust assets for the benefit of the disabled beneficiary and distribute them pursuant to the terms of the SNT. Exhibit 2 illustrates a “zeroed-out” Walton GRAT in which the assets contributed to the GRAT are anticipated to grow by 8% each year and the applicable Section 7520 rate for calculating the annuity payment is 4.2%.

Using the same assumptions as in Exhibit 2, but substituting an increasing annuity payment for the fixed annuity payment shown in Exhibit 2, the amount of the GRAT remainder paid to the SNT is increased (see Exhibit 3). The reason is that the GRAT assets are allowed to grow in value in the initial years when the required annuity payment is less than the growth on the trust assets.

Combining GRAT, FLP, and SNT for maximum leverage. The tax efficiencies achieved through the use of a GRAT combined with an SNT can be further enhanced by combining a family limited partnership (“FLP”) or family limited liability company (“FLLC”) with the GRAT and SNT. Assuming the underlying asset continues to appreciate at 8% and assuming a relatively conservative discount from FMV for gift tax purposes through use of an FLP or FLLC, the yield on the GRAT assets is increased to 10.667%.

This can be illustrated as follows (see Exhibit 4): (1) an asset with an FMV of $1 million is transferred to an FLP and, as the result of the lack of marketability and minority interest discounts, is valued at $750,000 for gift tax purposes; (2) the underlying asset grows $80,000 in value the first year; (3) the $80,000 in growth divided by the discounted gift tax value of $750,000 equals a return on investment of 10.667% (80,000/750,000). This increased performance due to the combination of the FLP with the GRAT, which is then payable to the SNT, allows $875,644 to be transferred to the SNT at no gift tax cost, as shown in Exhibit 4.

Of course, the client should take into account the IRS’s recent victories based on Section 2036 when considering whether to use
Combining CRT with SNT

Another tax-advantaged strategy that can be used to transfer assets to an SNT involves the combination of a charitable remainder trust ("CRT") with an SNT. The CRT can be designed as either a charitable remainder annuity trust ("CRAT") or a charitable remainder unitrust ("CRUT"). A CRAT requires that a fixed percentage of the initial contribution\(^{21}\) to the trust be paid to a noncharitable beneficiary for a period that can be measured by either the life or lives of designated individuals or a term of years, not to exceed 20 years.\(^{22}\)

A CRUT requires that a payment equal to a fixed percentage of years, not to exceed 20 years.\(^{23}\)

To qualify as a charitable split-interest trust, a CRT must have at least one beneficiary that is not a qualified charitable organization. Any "person"\(^{24}\) can be a beneficiary, including an individual, trust, estate, corporation, company, or association. Because a trust is not an individual with a life expectancy, a CRT with a trust as beneficiary generally must be limited to a term no greater than 20 years.\(^{25}\)

Exhibits 5 and 6 demonstrate the use of a CRAT and a CRUT to fund a lifetime SNT. Each CRT is funded with assets valued at $500,000. The CRAT requires a fixed payment of $33,700 to be paid to the SNT annually during the 20-year term. At the end of 20 years, the SNT is funded with $1,254,176.\(^{26}\)

Exhibit 7 compares the liquidation date, as revalued annually during the 20-year term, of the SNT assets if the CRUT remainder will be paid to a charitable income tax deduction of $50,222 in the year of contribution. Based on the projected rate of return, the CRAT would distribute $788,300 to the charity upon termination of the CRAT, as shown in Exhibit 5.

The CRUT illustrated in Exhibit 6 requires a payment equal to 11.293% of the value of the CRUT, as revalued annually during the 20-year term. At the end of 20 years, the SNT is funded with $1,641,959.\(^{27}\) The value of the initial gift to the CRUT for gift tax purposes is $449,778. Because the CRUT remainder will be paid to a qualified charity at the end of the 20-year term, the grantor is entitled to a charitable income tax deduction of $50,222 in the year of contribution. Based on the projected 8% rate of return, the CRUT would distribute $251,979 to the charity upon termination of the CRUT.

The use of a CRT with payments based on the life expectancy of the special needs beneficiary was
first approved by the IRS in Rev. Rul. 76-270. On 4/26/02, the IRS amplified the concept presented in Rev. Rul. 76-270 and superseded that Ruling with Rev. Rul. 2002-20. Rev. Rul. 2002-20 involved the creation of a CRUT made payable to an SNT set up for the benefit of a "financially disabled" individual.

The Service ruled that unitrust payments from a CRT to an SNT may be measured by the life of the SNT's beneficiary, if such beneficiary is unable to manage his or her own affairs by reason of a medically determinable physical or mental impairment that can be expected to result in death or that has lasted or can be expected to last for a continuous period of not less than 12 months, and in the following three situations:

1. The trustee of the trust is required to make specified monthly distributions to the disabled beneficiary, and the trustee has discretion to make additional distributions for the care, support and maintenance of the beneficiary, with the balance of the trust assets distributed to the disabled beneficiary's estate upon such beneficiary's death.

2. The trustee of the trust may make distributions of income and principal, as determined in the trustee's sole discretion, for the financial aid and best interests of the disabled beneficiary, but only in a manner that supplements but does not replace any government assistance otherwise available to the beneficiary. Upon the death of the beneficiary, the trust instrument must require the trustee to reimburse the state for the total cost of the medical assistance provided to the beneficiary under the

3. The trustee of the trust may make distributions of income and principal, as determined in the trustee's sole discretion, for the financial aid and best interests of the disabled beneficiary, but only in a manner that supplements but does not replace any government assistance otherwise available to the beneficiary. Upon the death of the beneficiary, the trust instrument must require the trustee to reimburse the state for the total cost of the medical assistance provided to the beneficiary under the

---

**EXHIBIT 5**
Use of a CRAT With an SNT

<table>
<thead>
<tr>
<th>Year</th>
<th>CRAT Beginning Principal</th>
<th>Growth of CRAT at 8% Rate</th>
<th>6.74% Annuity Payment to SNT</th>
<th>CRAT Remainder to Charity in Year 20</th>
<th>Value of SNT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$500,000</td>
<td>$40,000</td>
<td>$33,700</td>
<td>$788,300</td>
<td>$35,587</td>
</tr>
<tr>
<td>5</td>
<td>526,389</td>
<td>42,271</td>
<td>33,700</td>
<td>788,300</td>
<td>199,012</td>
</tr>
<tr>
<td>10</td>
<td>578,672</td>
<td>46,294</td>
<td>33,700</td>
<td>788,300</td>
<td>460,349</td>
</tr>
<tr>
<td>15</td>
<td>652,554</td>
<td>52,204</td>
<td>33,700</td>
<td>788,300</td>
<td>803,527</td>
</tr>
<tr>
<td>20</td>
<td>781,111</td>
<td>60,889</td>
<td>33,700</td>
<td>788,300</td>
<td>1,254,176</td>
</tr>
<tr>
<td>Summary</td>
<td>$56,465</td>
<td>$674,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**EXHIBIT 6**
Use of a CRUT With an SNT

<table>
<thead>
<tr>
<th>Year</th>
<th>CRUT Beginning Principal</th>
<th>Growth of CRUT at 8% Rate</th>
<th>11.293% Unitrust Payment to SNT</th>
<th>CRUT Remainder to Charity in Year 20</th>
<th>Value of SNT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$500,000</td>
<td>$39,624</td>
<td>$56,465</td>
<td>$251,979</td>
<td>$59,627</td>
</tr>
<tr>
<td>5</td>
<td>435,962</td>
<td>34,549</td>
<td>49,233</td>
<td>251,979</td>
<td>312,892</td>
</tr>
<tr>
<td>10</td>
<td>367,322</td>
<td>29,109</td>
<td>41,482</td>
<td>251,979</td>
<td>674,509</td>
</tr>
<tr>
<td>15</td>
<td>309,489</td>
<td>24,526</td>
<td>34,951</td>
<td>251,979</td>
<td>1,107,864</td>
</tr>
<tr>
<td>20</td>
<td>260,762</td>
<td>20,665</td>
<td>29,448</td>
<td>251,979</td>
<td>1,641,959</td>
</tr>
<tr>
<td>Summary</td>
<td>$583,531</td>
<td>$1,641,959</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

27. This figure assumes that (1) the SNT assets are reinvested at 8% annually, (2) the SNT or the SNT beneficiary pays income taxes at a combined federal and state tax rate of 30% (part ordinary income and part capital gain taxes), and (3) no distributions are made to the disabled beneficiary during the 20-year term.
28. 1976-2 CB 194. This Ruling involved a CRT that made distributions to a trust for a mentally incompetent individual.
29. 2002-1 CB 794.
30. Because of the mandated monthly distributions to the trust beneficiary and such beneficiary's right to enforce distributions for care, support and maintenance, this type of trust would be ineffective to preserve government assistance for the disabled beneficiary.
31. Because of the discretionary nature of this trust, the assets of this trust would not be considered an available resource of the beneficiary for purposes of determining eligibility for Medicaid.
state’s Medicaid plan. Any excess over the required reimbursement amount can be distributed pursuant to the disabled beneficiary’s testamentary general power of appointment, or if the power is unexercised, as provided under the trust instrument.32

Exhibit 7 illustrates a CRUT and SNT strategy based on Situation 3 of Rev. Rul. 2002-20. Assume the grantor makes a contribution of $500,000 to the CRUT. The CRUT will make a 5.667% unitrust payment to an SNT for the benefit of a disabled beneficiary who is 30 years old upon execution of this strategy. The illustration assumes that the assets of the CRT and the SNT each earn 8% annually for the life of the beneficiary and there are no distributions during the disabled beneficiary’s lifetime. The initial taxable gift to the CRT is $449,870, and the grantor would be eligible to take a $50,130 charitable income tax deduction in the year of contribution.

This strategy appears superior to the 20-year CRT/SNT strategies discussed earlier, but two additional factors must be kept in mind in evaluating the two concepts. First, the lifetime strategy requires reimbursement of the state’s Medicaid agency, which is not required with the 20-year strategy. Second, under the lifetime strategy, payments from the CRT to the SNT cease upon the death of the special needs beneficiary, whereas with the 20-year CRT, the payments would continue for the balance of the 20-year term—regardless of the death of the beneficiary. These factors may lead to the selection of the 20-year strategy in some circumstances where the special needs beneficiary is unlikely to live his or her full life expectancy and where the grantor has a strong desire to maximize distributions to remainder beneficiaries under the SNT.

Combining CLAT with SNT
A lifetime nongrantor charitable lead annuity trust (“CLAT”) can be combined with a residual SNT to fund an SNT in the future at no gift tax cost. A CLAT is the opposite of a CRT—it is a split-interest trust that provides for annuity payments to a charity for a set term, with the remainder interest to be paid to a noncharitable beneficiary. If the present value of the annuity stream paid to the charity is equal to the value of the initial contribution to the CLAT, the gift of the remainder interest to the SNT would be valued at zero for gift tax purposes.33

For instance, an inter vivos CLAT can be funded with a lump sum of $500,000. The CLAT would have a term of 20 years, during which time the trustee of the CLAT would make payments of $37,445 annually to one or more designated charitable organizations. At a Section 7520 rate of 4.2%, the present value of the annuity payments to the charity is $500,000. Thus, for gift tax purposes, the value of

---

32 Id
33 For more on structuring CLTs, see Zaritsky, Tax Planning for Family Wealth Transfers: Analysis with Forms ¶ 5.04 (Warren, Gorham & Lamont, a division of RIA, 2005); Silk and Lintott, “Using a CLT and Private Foundation to Nearly Eliminate Estate Tax,” 29 ETPL 22 (Jan. 2002).
the remainder interest in the CLAT, which is payable to an SNT at the expiration of the annuity term, is zero. If the CLAT assets grow at a rate of 8% annually, the value of the remainder interest would be $616,907 in 20 years, as shown in Exhibit 8.

A CLAT does not qualify as a charitable trust under the Internal Revenue Code. Instead, if the CLAT is structured as a grantor trust, the grantor would be entitled—in the year the CLAT is created—to a charitable income tax deduction for the present value of the stream of annuity payments that will be made to charity, but the annual income earned by the CLAT would be taxable to the grantor (without a further annual charitable income tax deduction) during the term of the CLAT. If the CLAT is structured as a nongrantor trust, the grantor is not entitled to an up-front charitable income tax deduction, but the CLAT would be allowed to offset the annual annuity payments as a charitable income tax deduction against the income earned by the CLAT each year. Under the scenario presented above, the grantor would likely structure the CLAT as a nongrantor trust in order to shelter as much of the CLAT income as possible during the period that annuity distributions are being made to the charity.

Conclusion
The strategies discussed here, and many others, are available to taxpayers with potential estate tax liabilities who wish to fund a special needs trust in a gift and/or estate tax-efficient manner. All it takes is some creativity in combining classic advanced estate planning vehicles (such as the QPRT, the GRAT, the CRT, and the CLT) with an SNT for the disabled beneficiary.

34 Section 170(f)(2)(B).