Thoughts about the Administration’s Proposal to Modify Generation-Skipping Transfer (GST) Tax Treatment of Health And Education Exclusion Trusts (HEETs)
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I. What is a “HEET?”

The term HEET is generally used to describe a trust that explicitly permits or requires trust distributions to be made directly to health care providers and/or to educational institutions to pay medical expenses and tuition costs of a trust beneficiary and does so in such a way as to avoid a direct skip on funding or a taxable termination as one or more generations of beneficiaries die or become ineligible to benefit from trust distributions. In some cases, the HEET is created for only one generation of beneficiaries and then terminates in favor of charity. In others, the HEET is designed to last for multiple generations and to terminate in favor of charity only if there are no other living individuals who the creator of the trust desires to benefit. Often a charity is included as a beneficiary during the term of the trust (either immediately on funding or after a period of time or on the occurrence of a specific event), which allows taxpayers to claim that the transfer to the trust is not a direct skip or that the termination of the interest in the trust of the last individual beneficiary in a specific generation does not cause a taxable termination.

II. The Administration’s HEET Proposal (see Appendix A).

The so-called HEET Proposal as set forth in the “General Explanations of the Administration’s Fiscal Year 2015 Revenue Proposals” (the “Greenbook”) is as follows:

“The proposal would provide that the exclusion from the definition of a GST under section 2611(b)(1)\(^1\) applies only to a payment by a donor directly to the provider of medical care or to the school in payment of tuition and not to trust distributions, even if for those same purposes.

“The proposal would apply to trusts created after the introduction of the bill proposing this change, and to transfers after that date made to pre-existing trusts.”

III. The Administration’s HEET Proposal is flawed because it misconstrues section 2611(b)(1).

A. In General. Section 2611(b)(1) is one of two GST tax provisions that apply the policy behind section 2503(e)\(^2\) to the GST tax. The other is section 2642(c). The Greenbook description inaccurately describes section 2611(b)(1), ignores section 2642(c) and confuses and conflates these two provisions. If the Administration’s HEET Proposal

\(^1\) All section references in this outline are to the Internal Revenue Code of 1986, as amended.
\(^2\) Section 2503(e) provides that payments made by a donor directly to the provider of medical care for another person or directly to a school for another person’s tuition are exempt from gift tax.
were implemented, section 2611(b)(1), as it now exists, would cease to exist and what would replace it would duplicate a portion of section 2642(c). Put differently, the Administration’s HEET Proposal is a proposal to effectively repeal section 2611(b)(1) in its entirety in the guise of modifying it. Moreover, by proposing an effective date based on the date of introduction of the proposal rather than the date of enactment, the Administration’s HEET Proposal treats a legitimate estate planning technique based on existing provisions of current law as an abusive transaction. This is inappropriate.

B. More specifically:

1. Section 2642(c) provides, inter alia, that to the extent a transfer is not treated as a taxable gift by reason of section 2503(c), the inclusion ratio of the property transferred shall be zero, thereby effectively exempting the transfer from GST tax.

2. Section 2611(b)(1), on the other hand, allows trustees to make direct payments of tuition and medical expenses without triggering a GST tax by specifically exempting from the definition of a “generation-skipping transfer” (a transfer subject to GST tax) “any transfer which, if made during the donor’s life, would not be treated as a taxable gift by reason of section 2503(c).”

3. The statement in the Greenbook that the “intent of section 2611(b)(1) is to exempt from GST tax only those payments that are not subject to gift tax, that is, payments made by a living donor directly to the provider of medical care for another person or directly to a school for another person’s tuition” accurately describes the purpose behind section 2642(c), not the purpose behind section 2611(b)(1).

4. The result accomplished through section 2611(b)(1) could be achieved in the absence of section 2611(b)(1) through a distribution to an individual non-skip person (such as a child of the transferor who chooses to use the funds received to pay the tuition or medical expenses of an individual skip person (such as a grandchild or great grandchild of the transferor), who may also be a trust beneficiary.

IV. The Administration’s HEET Proposal misconstrues the way in which HEETs arguably violate the policy behind the GST tax.

A. The Arguable Policy Violation. To the extent, if any, that the HEET technique could be considered to violate the policy behind the GST tax, we believe that the policy being violated is not the avoidance of GST tax on direct payments of tuition and medical expenses as explicitly and purposefully provided in section 2611(b)(1), but rather the inclusion or temporary exclusion of other trust beneficiaries in a manner that avoids a direct skip, or avoids or postpones a taxable termination, with respect to a HEET. Thus, HEETs can be viewed as a method of postponing or avoiding GST tax to the extent (and only to the extent) that beneficiaries (including charities) are named (or
temporarily excluded) in an effort to avoid the imposition of a GST tax on a direct skip or a taxable termination that would otherwise have resulted, particularly if the HEET is designed and used to benefit successive generations of skip persons without incurring an estate or GST tax as the trust benefits pass from one generation to another.

B. The Fix to the Fix that Already Exists. The GST tax already includes a provision, section 2652(c), allowing the Internal Revenue Service to ignore beneficiaries included primarily to postpone or avoid the GST tax. To the extent that the Administration thinks it desirable to prevent taxpayers from using HEETs in this way, an appropriate solution would be to strengthen section 2652(c)(2) to ensure that a GST tax will be paid at each generation. For example, section 2652(c) could be modified to:

1. Apply not only to disregard interests included primarily to avoid or postpone the GST tax but also to disregard a delay in trust benefits primarily to avoid giving a person an interest and thereby to avoid or postpone the GST tax and

2. To add a rebuttable presumption of a primary intent to avoid or postpone GST tax when a non-skip person who is not an individual (such as a charity or a section 501(c)(4) entity) is given an interest in a trust other than a charitable remainder trust or a charitable lead trust.
General Explanations
of the
Administration’s Fiscal Year 2015
Revenue Proposals

Department of the Treasury
March 2014
MODIFY GENERATION-SKIPPING TRANSFER (GST) TAX TREATMENT OF HEALTH AND EDUCATION EXCLUSION TRUSTS (HEETS)

Current Law

Payments made by a donor directly to the provider of medical care for another person or directly to a school for another person’s tuition are exempt from gift tax under section 2503(e). For purposes of the GST tax, section 2611(b)(1) excludes “any transfer which, if made during the donor’s life, would not be treated as a taxable gift by reason of section 2503(e).” Thus, direct payments made during life by an older generation donor for the payment of these qualifying expenses for a younger generation beneficiary are exempt from both gift and GST taxes.

Reasons for Change

Some taxpayers have interpreted the language of section 2611(b)(1) as permitting the avoidance of GST tax through the use of a trust known as a HEET. A HEET provides for the medical expenses and tuition of multiple generations of descendants. Taxpayers using this technique take the position that section 2611(b)(1) exempts these trust distributions from GST tax (generally, in perpetuity) because the distributions are used for the payment of medical care expenses and tuition. The substantial amounts contributed to HEETs will appreciate in these trusts, and taxpayers claim that no estate, gift, or GST tax will ever be incurred after the initial funding of these trusts.

The intent of section 2611(b)(1) is to exempt from GST tax only those payments that are not subject to gift tax, that is, payments made by a living donor directly to the provider of medical care for another person or directly to a school for another person’s tuition.

Proposal

The proposal would provide that the exclusion from the definition of a GST under section 2611(b)(1) applies only to a payment by a donor directly to the provider of medical care or to the school in payment of tuition and not to trust distributions, even if for those same purposes.

The proposal would apply to trusts created after the introduction of the bill proposing this change, and to transfers after that date made to pre-existing trusts.