

Naming a Supplemental Needs Trust as a Beneficiary of a Charitable Remainder Trust

By George H. Gray

Under the proper circumstances, an effective and attractive planning strategy is to name a third party supplemental needs trust (a "SNT") as an income beneficiary of a charitable remainder trust (a "CRT"). The proper circumstances arise if the grantor:



- a) has a loved one with a disability and who is receiving means tested government benefits, such as Supplemental Security Income ("SSI") or Medicaid; and
- b) has charitable intentions and a charity which he/she wishes to benefit as part of his/her estate plan; and *either*
- c) during his/her lifetime has appreciated property which the grantor wishes to sell and to shelter the gain on the sale; *or*
- d) upon his/her death wishes to use a qualified retirement account to fund the SNT, while at the same time benefitting a tax-exempt organization.

A CRT¹ is a "split-interest" charitable trust which is irrevocable and in which the economic and beneficial rights under the trust are split between non-charitable individuals or entities and one or more tax exempt organization.² A CRT consists of two distinct components: (i) a private interest in the form of a right to a stream of payments to a non-charitable beneficiary each year; and (ii) a charitable interest in the assets remaining in the trust. Properly structured and administered, a CRT is exempt from income tax and affords the grantor a charitable gift or estate tax deduction for the property contributed to the CRT.

There are two types of CRTs: a charitable remainder annuity trust (a "CRAT") and a charitable remainder unitrust (a "CRUT"). A CRT is a creature of the Internal Revenue Code and an exception to the general rule that a taxpayer cannot receive a charitable deduction for a "split-gift" to a charity. Because a CRT is a creature of statute, there are specific characteristics which must be present in each.³

A CRAT must have the following characteristics:⁴

- a) The CRAT pays a sum certain:

- (i) which is not less than 5% nor more than 50% of the initial net fair market value of all property placed in trust (expressed as either as a fraction or a percentage of the net fair market value);
- (ii) not less often than annually;
- (iii) to one or more persons (at least one of which is not a tax-exempt organization); and
- (iv) for a term of years (not in excess of 20 years) or for the life or lives of such individual beneficiary(ies).

- b) At the termination of the payments described in subparagraph "a" above, the remainder interest in the trust will be transferred to, or for the use of, a tax-exempt organization.
- c) The value of the charitable remainder interest must be at least 10% of the initial net fair market value of all property placed in the trust.

A CRUT must have the following characteristics:⁵

- a) The CRUT pays an amount:
 - (i) which is fixed percentage not less than 5% nor more than 50% of the net fair market value of the trust assets as valued annually (expressed as either as a fraction or a percentage of the net fair market value);
 - (ii) not less often than annually;
 - (iii) to one or more persons (at least one of which is not a tax-exempt organization); and
 - (iv) for a term of years (not in excess of 20 years) or for the life or lives of individual beneficiary(ies).
- b) At the termination of the payments described in subparagraph "a" above, the remainder interest in the trust will be transferred to, or for the use of, an tax-exempt organization.
- c) With respect to each contribution of property to the trust, the value of the charitable remainder interest in such property is at least 10% of the net fair market value of such property as of the date such property is contributed to the trust.

The grantor's charitable deduction for contributions to a CRT is equal to the remainder of: (i) the value of the property contributed to the CRT; minus (ii) the net present value of the unitrust or annuity payments made during the term of the CRT. The value of the charitable remainder interest is determined using the §7520 interest rate for the month of the transfer to the CRT. However, the grantor may elect to use the §7520 interest rate for either of the two months preceding the month of transfer. All other things being equal, the higher the §7520 interest rate, the larger the charitable deduction. In the present low interest rate environment, the strategy of using a CRT to fund an SNT is of limited value to a grantor who seeks to maximize the charitable deduction.

A CRUT may receive additions to the trust assets by transfers of property made during the grantor's life or at his/her death. No additions can be made to a CRAT once it is funded.

The payout of a CRAT does not vary and it doesn't matter how much income is earned by the trust during the year. If assets held by the CRAT are producing substantial gains, the non-charitable beneficiary won't benefit. If income is insufficient to support the payout the difference is made up from the principal of the CRAT. Because the annuity is fixed, the non-charitable recipient receives no benefit from any appreciation in trust assets from year to year. On the other hand, the unitrust amount paid to the income beneficiary of a CRUT does vary with the performance of the underlying trust property. If the CRUT does well in its investments, it will increase in value and the unitrust amount will, in turn, increase. If the CRUT's investments do poorly in a year, the unitrust amount for the next year will correspondingly decrease.

The non-charitable interest of a CRT is payable to a "person." The definition of "person" includes a trust, estate, partnership, association, company, or corporation.⁶ Thus, an SNT is a permissible income beneficiary of a CRT, although the term of the CRT is limited to 20-years or less.

A contribution of appreciated property to the CRT is an efficient way to shelter the gain on a subsequent sale by the CRT. Further, the Grantor of an *inter vivos* CRT receives an immediate income tax charitable deduction for the contribution made to the CRT, while the contribution of assets to a testamentary CRT would generate an estate tax charitable deduction.⁷ Likewise, if a CRT is named the beneficiary of a qualified retirement account, the "required minimum distributions" to the CRT are not subject to an income tax and the entire retirement account balance is available to be invested tax free until the unitrust or annuity amounts are distributed to the income beneficiaries of the CRT.

A properly created and maintained SNT will not jeopardize a disabled beneficiary's⁸ eligibility for "means tested" government benefits. The use and purpose of a SNT is to provide funds for the use and benefit of a disabled beneficiary to pay for items which supplement but do not supplant, impair or diminish any benefits, assistance or payment of any governmental entity. Most importantly, the property and assets in the SNT are disregarded as a resource for purposes of determining the disabled beneficiary's eligibility for Medicaid and SSI benefits. One of the main benefits of the SNT is to enhance the beneficiary's quality of life by providing for the purchase of additional support, services, therapies and other items that are not covered by or provided adequately for by available government programs.

A "third-party" SNT is funded with property or assets contributed by any person *other than* the person with a disability, such as a parent, grandparent or other interested person or relative. The SNT can accept contributions from "third parties" even after its initial funding.

There is one other defining feature of a Third Party SNT worthy of note. The money and property remaining in the SNT at the beneficiary's death *need not* be used to "pay back" the State for Medicaid benefits paid on the beneficiary's behalf. In other words, the grantor may direct the money remaining in the SNT to any persons or entities he/she desires. Many times in the deliberation of how much should be used to fund the SNT the grantor may worry "how much is too much"? That worry is mitigated and the decision is made easier by the realization by the grantor that he/she can name family members as residuary beneficiaries of the SNT.

Third party supplemental needs trusts are referenced in section 7-1.12 of the Estates Powers and Trusts Law⁹ (the "EPTL"). That section of New York law describes an SNT as a discretionary trust. As such, it makes sense that the grantor can do with his/her property what he/she wishes, including disinheriting a disabled beneficiary altogether. To the extent that the grantor wishes to create a trust which explicitly limits or restricts the availability of trust funds so that the beneficiary can maintain his/her eligibility for "means tested" government benefits, the grantor should be free to do so and to determine the ultimate disposition of the trust corpus at the death of the disabled beneficiary.

If the SNT is named as the income beneficiary of a CRT, it will receive a mandatory unitrust or annuity amount each year. That being the case, the SNT trustee must engage in intentional income tax planning for these amounts which will be received, but may not always be needed.

The character of the distributions from the CRT to the SNT during the tax year is determined using a

four-tier system.¹⁰ This system divides the unitrust or annuity amount received during the tax year into four categories: (i) ordinary income; (ii) capital gains; (iii) other income; and (iv) return of trust corpus. A distribution is first treated as ordinary income to the extent of the sum of the CRT's current-year or accumulated ordinary income. When the current-year and accumulated ordinary income is exhausted, the ordering proceeds to the second category (capital gains). When capital gains are exhausted, the ordering proceeds to the third category (other income). Finally when all income is exhausted, the distribution is considered a return of corpus. Thus, the annual distributions from the CRT are guaranteed to be characterized (at least in part) as income to the SNT.

Like all trusts, the income tax brackets for an SNT are greatly compressed. An SNT is taxed at the 39.6% tax bracket on income above \$12,300; whereas, a single taxpayer would have to earn in excess of \$413,200 to attain the same high tax bracket. The CRT is mandated to make a distribution each year, and each distribution carries with it income tax consequences to the SNT. There are a number of strategies which can be engaged to manage the income tax bite to the SNT.

- a) The most straight forward technique to minimize tax is for the SNT to make distributions for the benefit of the disabled beneficiary which will afford the SNT a distribution deduction;¹¹ and, in turn "pass-thru" the income to the beneficiary to be taxed at his/her lower bracket. But...there are limits on this technique because it is based upon the needs of the beneficiary which may not match the level of the optimal distributions from the SNT. That being said, it is a useful technique when the disabled beneficiary has high medical expenses which are not covered by Medicaid. In that instance, the SNT beneficiary can deduct the medical expenses in excess of 10% of his/her adjusted gross income and thereby shelter the distributions from the CRT which "pass through" the SNT to the beneficiary.
- b) Because the third party SNT is generally neither a "simple trust"¹² nor a "grantor trust,"¹³ it classified for tax purposes as a "complex trust."¹⁴ As such, it is required to report income on a Form 1041 and to pay a tax on the amount earned with only a \$100 personal exemption. However, an SNT can qualify as a "qualified disability trust,"¹⁵ and if it does it is entitled to a \$4,000 personal exemption.¹⁶ This personal exemption can be used by the trustee of the SNT to shelter the income which may be accumulated in the SNT and not distributed to the beneficiary. A qualified disability trust is one which (i) is a "complex trust"; (ii) is established for a disabled beneficiary under the age of 65; and (iii)

the income beneficiary is eligible to receive SSI or SSDI benefits.

- c) The \$4,000 personal exemption available to a "qualified disability trust" is *in addition* to the personal exemption and standard deduction available to the disabled beneficiary on amounts distributed to him/her. Thus, in the simplest of scenarios, a \$14,300 unitrust or annuity amount distributed by the CRT would be fully sheltered from tax if: (i) the SNT retained \$4,000 (sheltered by its personal exemption amount); and (ii) it distributed \$10,300 to the beneficiary (sheltered by the beneficiary's \$4,000 personal exemption and \$6,300 standard deduction). This scenario does not account for the deductions otherwise available to the SNT¹⁷ which would further reduce or eliminate the Income Tax.
- d) A CRT is not restricted to one recipient of the unitrust or annuity amount; there may be multiple income beneficiaries. A charity may be the recipient of part of the annuity or unitrust amount so long as there is at least part of the amount going to a non-charitable beneficiary each year. Further, the CRT can be designed to give the trustee the power to allocate or "sprinkle" the unitrust or annuity amount between or among income recipients. Thus, if the SNT could not make full use of the entire unitrust or annuity amount required to be distributed in a year, the trustee of the CRT could allocate the unneeded portion to another income beneficiary of the CRT. However, in order to avoid treatment as a grantor trust, a CRT trustee that is granted sprinkling powers must be "independent."¹⁸ Generally speaking, to be "independent" the trustee may not be a person who has a beneficial interest in the trust; a contributor to the trust; a beneficiary of the trust; a spouse; former spouse; ancestor; descendant; sibling or employee of a contributor or beneficiary.

The strategy proposed by this article is best demonstrated by the following examples.

Example 1:

Strategy—If the grantor is faced with a significant capital gains tax bill upon the imminent sale of a greatly appreciated asset, grantor could create a CRUT and contribute the appreciated asset to the CRUT prior to sale. The CRUT would name an SNT established for the benefit of a loved one with a disability as the recipient of the unitrust amount during the 20-year term of the CRUT. The grantor would name the not-for-profit social services organization providing services to the disabled beneficiary as the recipient of the charitable remainder interest of the CRUT.

Economic Outcome—Assume the grantor contributes \$300,000 in August, 2015 to the CRUT, which is designed to provide an annual unitrust amount of 5%. Assume further that the CRUT has a 4% return on its investments.

- a) The amount of the charitable deduction available to the grantor in 2015 is \$109,093;
- b) the unitrust amount ranges between \$15,000 in the first year and \$12,215 in the 20th year;
- c) the total estimated unitrust payments to the SNT over the 20-year term is \$271,251; and
- d) the estimated payment of the charitable remainder interest to the favored charity in August 2035 is \$241,680.

Example 2:

Strategy—If the grantor is faced with a significant capital gains tax bill upon the imminent sale of a greatly appreciated asset, the grantor could create a CRAT and contribute the appreciated asset to the CRAT prior to sale. The CRAT would name an SNT established for the benefit of a loved one with a disability as the recipient of the annuity amount during the 20-year term of the CRAT. The grantor would name the not-for-profit social services organization providing services to the disabled beneficiary as the recipient of the charitable remainder interest of the CRAT.

Economic Outcome—Assume the grantor contributes \$300,000 in August, 2015 to the CRAT which is designed to provide an annual annuity amount of 5%. Assume further that the CRAT has a 4% return on its investments.

- a) The amount of the charitable deduction available to the grantor in 2015 is \$57,424;
- b) the annuity amount payable to the SNT in each of the 20 years is \$15,000;
- c) the total annuity payments to the SNT over the 20-year term is \$300,000; and
- d) the estimated payment of the charitable remainder interest to the favored charity in August 2035 is \$203,965.

Analysis of Examples 1 and 2—The contribution of the appreciated asset generates an immediate income tax charitable deduction for the grantor. Because the CRT itself is tax-exempt, any gain on subsequent sale of the appreciated asset out of the CRT is sheltered from any capital gains tax. There is, however, an income tax to be paid, but by the SNT and only on the dollars distributed to the SNT as the annuity or unitrust amount. However, the Income Tax impact can be eliminated using: (i) the personal exemption of the SNT and the

beneficiary; (ii) other deductions available to the SNT; and (iii) the beneficiary's standard or itemized deductions. Further, because they are undiminished by the payment of the capital gains tax, the entire \$300,000 of proceeds are available for investment by the CRT and can grow tax free until distributions are made from the CRT.

The SNT is created using the model language contained in EPTL 7-1.12, together with the draftsperson's other trust language governing the administration of the SNT. It is designed to be a "qualified disability trust" to take advantage of the \$4,000 personal exemption. Because it is a "third party" supplemental needs trust, the grantor can name any person or entity (including the favored charity) as the remainder beneficiary of the SNT.

Example 3:

The grantor names a CRUT as beneficiary to receive his/her IRA or qualified retirement account balance at the death of the grantor. The CRUT would name an SNT established for the benefit of a loved one with a disability as the recipient of the annuity amount during the 20-year term of the CRUT. The grantor would name the not-for-profit social services organization providing services to the disabled beneficiary as the recipient of the charitable remainder interest of the CRUT.

Economic Outcome—Assume the amount in the grantor's IRA at death is \$300,000. Assume that the CRUT is funded in August, 2015 with an RMD of the entire \$300,000 IRA balance. The CRUT is designed to pay an annual unitrust amount of 12.75%. Assume further that the CRUT has a 4% return on investments.

- a) The amount of the Estate Tax charitable deduction is \$30,006;
- b) the unitrust amount will range between \$33,072 in the first year to \$8,013 in the 20th year;
- c) the total estimated unitrust payments to the SNT over the 20-year term is \$356,564; and
- d) the estimated payment of the charitable remainder interest is \$67,464.

Example 4:

The grantor names a CRAT as beneficiary to receive his/her IRA or qualified retirement account balance at the death of the grantor. The CRAT would name an SNT established for the benefit of a loved one with a disability as the recipient of the annuity amount during the 20-year term of the CRAT. The grantor would name the not-for-profit social services organization providing services to the disabled beneficiary as the recipient of the charitable remainder interest of the CRAT.

Economic Outcome—Assume the amount of a grantor’s IRA at death is \$300,000. Assume that the CRAT is funded in August, 2015 with an RMD of the entire \$300,000 IRA balance. The CRAT is designed to pay an annual unitrust amount of 5.56%. Assume further that the CRAT has a 4% return on investments.

- a) The amount of the Estate Tax charitable deduction is \$30,255;
- b) the annuity amount paid in each year is \$16,800;
- c) the total estimated unitrust payments to the SNT over the 20-year term is \$333,600; and
- d) the estimated payment of the charitable remainder interest is \$153,188.

Analysis of Examples 3 and 4—If a grantor names a trust which also benefits both an individual and a non-individual (*e.g.*, a charity) as the beneficiary of his or her IRA, the trust is generally required to take the entire amount of the IRA balance as an RMD within five years of the date of the grantor’s death.¹⁹ This will result in the loss of the opportunity to “stretch” payments from the IRA over a period measured by the life expectancy of the oldest individual beneficiary of the trust and thereby defer the income tax due.

The contribution of the IRA account balance to the CRT generates an immediate estate tax charitable deduction for the grantor’s estate. Because the CRT itself is tax-exempt, the immediate distribution of the entire \$300,000 RMD is sheltered and there is no concern to “stretch” distributions from the IRA.

There is, however, an income tax to be paid, but by the SNT and only on the dollars distributed as the annuity or unitrust amount. However, the income tax impact can be mitigated using: (i) the personal exemption of the SNT and the beneficiary; (ii) other deductions of the SNT; and (iii) the beneficiary’s standard or itemized deductions. Alternatively, the grantor could name an additional tax exempt organization and/or “person” as an income beneficiary of the CRT. An “independent” trustee selected by the grantor can be given the power to “spray” distributions between or among some or all the several income beneficiaries. This would divert unwanted or unneeded unitrust or annuity amounts away from the SNT to effectively reduce or eliminate the income tax consequence to the distribution.

Further, because they are undiminished by the payment of an Income Tax, the entire \$300,000 RMD are available for investment by the CRT and can grow tax free until distributions are made from the CRT.

The SNT is created using the model language contained in EPTL 7-1.12, together with the draftsperson’s other trust language governing the administration of the SNT. It is designed to be a “qualified disability trust” to take advantage of the \$4,000 personal exemp-

tion. Because it is a “third party” supplemental needs trust, the grantor can name any person or entity (including the favored charity) as the remainder beneficiary of the SNT.²⁰

Endnotes

1. Section 664 of the Internal Revenue Code of 1986, as amended (the “Code”) defines the characteristics and restrictions of a charitable remainder trust.
2. I am using the term “tax-exempt” organization or “charity” to refer to an organization described in Code §170(c) which includes only a corporation, trust, or community chest, fund, or foundation: (a) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals; (b) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and (c) which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and (d) which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.
3. The IRS published sample trust instrument provisions that, if followed, would meet IRC 508(e) requirements. A series of revenue procedures were issued in 2003 that presented approved sample trust documents covering the various scenarios that a CRAT would typically involve. Rev. Proc. 2003-53 through Rev. Proc. 2003-60. In 2005, a series of revenue procedures were issued that provided sample trust instruments for various scenarios involving CRUTs. Rev. Proc. 2005-52 through Rev. Proc. 2005-59.
4. Code §664(d)(1).
5. Code §664(d)(2).
6. Code §7701(a)(1) contains the definition of a “person.”
7. In the case of a testamentary CRT, the exemption from the capital gains tax and the availability of an estate tax charitable deduction play a greatly diminished role in current estate planning. First, the step-up in basis of an appreciated asset at the death of the grantor will result in zero or very little tax imposed upon a subsequent sale. Further, the Federal Unified Credit Amount (currently \$5.430 million) shelters all but a very small percentage of estate from the Estate Tax. In New York, the Unified Credit Amount is now \$3.125 million and will soon increase to an amount equal the Federal Unified Credit Amount, thereby making an estate tax charitable deduction of value to a limited number of estates.
8. While I typically use “person first language” (“PFL”) and refer to a “person with a disability,” sometimes it is grammatically awkward to use that linguistic convention. There are articles published by a number of individuals with a disability which push back against PFL. One author expressed it this way:

as with almost any major activism movement, PFL sparked a counter-movement, known as identity-first. IFL is a linguistic concept embraced and actually preferred by countless people within the disability community. In the ideology of identity-first, “disabled” is a perfectly acceptable way for a person to identify. Instead of going out of your way to say “person with a disability,”

when using IFL you would instead say “disabled person.” This is how I personally choose to identify myself. I am a disabled person. *Why Person First Language Doesn’t Always Put the Person First*, Emily Ladau, *Think Inclusive* (July 20, 2015), <http://www.thinkinclusive.us>.

For simplicity of syntax, I have chosen to use IFL on several occasions in this article.

9. EPTL 7-1.12 was enacted in 1993 to provide model language for a “third party” supplemental needs trust. It was subsequently amended to include “first party” supplemental needs trusts, and the model language applies to both types of trusts.
10. Code §§664(b); see also Treas Regs §1.664-1(d).
11. Code §661(a).
12. Code §651.
13. See: Code §§671-679.
14. The IRS Manual on Charitable Trusts defines a complex trust as “...is any trust that doesn’t meet the requirements for a simple trust. Complex trusts may accumulate income, distribute amounts other than current income and, make deductible payments for charitable purposes under IRC 642(c).” IRS Manual §4.76.5.2.7 *Exempt Organization Examination Guidelines, Charitable Trusts (IRC 4947(a)(1) and 4947(a)(2))*, (4/13/2015).
15. Code §642(b)(2)(C).
16. The personal exemption for a qualified disability trust is equal to the personal exemption for an individual tax payer; and, thereby is increased year over year. In 2015 the personal exemption amount is \$4,000.
17. The disabled beneficiary would either take the standard deduction; or if he/she had tax deductions in excess of \$6,300, the sum of the itemized deductions.
18. Treas Reg. §1.674(c)-1 describes an “independent” trustee.
19. The rules regarding naming a trust as a beneficiary of a qualified retirement plan account are complex and often confusing. Likewise are the rules governing “required minimum distributions.” (“RMD”) An explanation of the subtle nuances of these rules is beyond the scope of this article and will render the example, intended to present the simplest of facts, unnecessarily complex.
20. See also IRS Rev.Rul. 2002-20 wherein the IRS confirms the utility of naming a First Party Supplemental Needs Trust as the beneficiary of both CRUTs and CRATs.

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