Quick-Take: A Health and Education Exclusion Trust (or, HEET) is one way to fund the education expenses and other medical expenses of multiple generations of trust beneficiaries without 'wasting' the settlor's generation skipping transfer tax (GSTT) exemption.

Background: The Tax Code provides that *direct* gifts for tuition and medical expenses qualifies for the annual exclusion from gift tax, and consequently no gift tax exemption is used to shelter that direct payment gift. [IRC 2503(e).]

> **GST:** Additionally, the Tax Code provides that for assets held in trust, a distribution directly to a provider for education, i.e., tuition, or medical expenses on behalf of a *beneficiary* is not considered a *taxable distribution* for generation skipping transfer tax purposes. IRC 2611(b)(1) excludes from the definition of a generation skipping transfer any trust that "*if made inter-vivos by an individual would not be treated as a taxable gift by reasons of Section 2503(e).*" Thus, a distribution from a non-exempt GST trust that is established for direct payments of tuition or medical expenses of a grandchild, or more remote descendant would not be considered a generation skipping transfer, because if that payment were made inter vivos, it would not be a taxable gift. In short, a distribution from a non-exempt generation skipping transfer (GST) trust that is established for direct payments of tuition or medical expenses of a grandchild, or a more remote descendant will *not* be considered a generation skipping transfer, because if that payment had been made inter vivos, it would not be a taxable gift under IRC 2503(e).
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> ***GST Taxable Termination:*** When assets are transferred to a trust

that is not exempt from the generation skipping transfer tax (GSTT), that transfer of funds will trigger an estate tax. Upon receipt, the trustee can use the trust funds, net of the federal estate tax, to continue to make transfers for educational and medical purposes without triggering the GSTT. Upon the death of the child-beneficiary, or upon the death of the last *non-skip person,* e.g., the settlor's child, who is a beneficiary of the non-exempt GST trust, a *taxable termination* will result, which again results in yet another GST tax that must be paid. Then, the trustee can continue to make such transfers for educational and medical purposes without triggering a gift tax. This is where the unique terms of a HEET come into play

HEET: A HEET is a Health and Education Exclusion Trust. HEET. A HEET is a dynasty-type of trust that is created to directly pay medical and tuition expenses of persons who are two or more generations younger than the HEET's settlor. In a HEET, a non-GST-exempt trust is established and funded by its settlor. As distributions are made from the HEET to its beneficiaries for the tuition or medical expenses of *non-skip* trust beneficiaries, no GST tax is due on the distributions made by the trustee. If those *non-skip persons,* e.g., the settlor's children who may also be trust beneficiaries, all die, meaning there are no more *non-skip person* beneficiaries of the trust, the trust is then treated as having terminated, thus triggering the GST's *taxable termination* tax.

Charitable Beneficiary: However, if a HEET adds yet another trust beneficiary, a charitable organization, the GST *taxable termination tax* disappears. Because the charitable organization is classified as a *non-skip person* for purposes of the GST tax, by vesting a charity with an interest in the HEET, that avoids taxable transfers either upon the creation or at any time of any subsequent distribution from the trust. Consequently, with the charity as one of the potential trust beneficiaries, the HEET will *never* experience a *taxable termination* for GST purposes. [IRC 2612(a)(1)(A).] Because the HEET never experiences a *taxable termination* due to the presence of the charitable beneficiary), no GST tax will conceivably ever be due

regarding the trust. The trust can continue to benefit *skip persons* for their health and tuition expenses. A donor advised fund established by the settlor at a publicly supported charity would qualify to receive the charitable distributions from the trust.

Substantial Economic Interest: The IRS imposes some restrictions on a HEET, which is that the charitable organization must have a *substantial present economic interest* in the trust, and not merely a theoretical interest. There is no guidance, however, on what constitutes a *substantial economic interest* in this situation. Without any IRS guidance, many experienced estate planning attorneys consider a 10% unitrust amount paid annually to the charity sufficient to document (or justify) that the charitable organization is a *bona fide* continual *non-skip person beneficiary* of the HEET.

Strategy: The presence of the charitable organization as a potential beneficiary of the trust thus indefinitely postpones a *taxable termination* of the GST non-exempt trust. It provides for the payment of the GST tax only upon a *taxable distribution* for non-health or non-educational expenses, which then allows the trustee to have control over, and deferral of, the GST tax.

***Grantor* Trust:** A HEET can also be structured as a *grantor* trust. [IRC 671-678.] If that is the case, the settlor is eligible to receive a charitable income tax deduction for income distributed by the trustee to the charitable beneficiary. After the settlor's death, the trust will then be treated as a separate taxpayer. The trust will be entitled to then take the charitable income tax deduction for amounts distributed to the charitable organization. [IRC 642(c).] Note, however, that if the HEET is then classified as a non-*grantor* trust, meaning it is a separate taxpayer, the trustee's payment of tuition expenses paid on behalf of a trust beneficiary may result in an income tax liability to that beneficiary if the charitable distribution has not exhausted all the trust's distributable net income (DNI.)

Practical Use of a HEET: A HEET generally works best for very wealthy individuals who have fully used their GST tax exemption. Like a dynasty trust, a HEET is typically established for the benefit of multiple beneficiaries with a trustee that determines, in its sole discretion, which beneficiaries will receive distributions and in what amounts. Less clear, given the discretionary nature of this trust, is its effect on a student-beneficiary's financial aid eligibility. More to the point, a HEET does not require any GST exemption allocated to it, which preserves the settlor's GST exemption for other transfers. And the HEET can be used to pay for tuition expenses at any level (but not room, board, books and related education fees or expenses, which is where a 529 account comes into play.)

GST Proposals: In the recent Treasury Proposal for this year's Budget, aka the 2024 *Greenbook,* it proposed placing restrictions on this estate planning strategy. The proposal is that for purposes of a GST *taxable termination,* any trust interests held by the charitable organization would be ignored.

Conclusion: HEETs are not all that prevalent in estate planning these days due to the large transfer tax exemption amounts available to donors. However, for those wealthy individuals who have fully consumed their available transfer tax exemptions with lifetime gifts, a HEET established for grandchildren and more remote descendants should at least be considered as part of their estate plan exploiting the GST's annual exclusion amount.

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