

(ii) Incomplete Gift – If there was an incomplete gift for gift tax purposes by the settlor when assets were contributed to the third-party supplemental needs trust, there will be gift tax consequences to the settlor if the trust terminates or continues and later distributes assets to a beneficiary or beneficiaries other than the settlor during the settlor's lifetime. See IRC § 2511.

3. Estate Tax

a. Settlor Dies Before The Primary Beneficiary – If the settlor of a third-party supplemental needs trust dies before the primary beneficiary, the assets will be included in the settlor's estate for estate tax purposes if the settlor retains certain powers over the trust assets, such as the power to revoke (see IRC § 2038), the power to designate beneficiaries (see IRC § 2036), the power to benefit from the trust (see IRC § 2036), the power to make trust property available to the settlor's general creditors (see IRC §§ 2036 and 2038), inter alia. Generally, see IRC § 2033. If trust assets are included in the settlor's estate for estate tax purposes, the trust assets will receive a "stepped up" basis. See IRC § 1014. When drafting the third-party supplemental needs trust, it is important to consider the tax planning options and alternatives that may be available to the primary beneficiary (which may be exercisable by the primary beneficiary, her agent, his conservator, or her guardian). It is also important to consider the non-tax issues with this type of planning, especially the Medicaid and public assistance eligibility, asset transfer, and estate recovery laws.

b. Primary Beneficiary Dies Before The Settlor – In most circumstances, special needs trusts are drafted so that trust assets will not be included in the primary beneficiary's gross estate for estate tax purposes upon the primary beneficiary's death due to Medicaid and estate recovery concerns. An interesting transfer tax planning opportunity presents itself if the assets of a third-party supplemental needs trust can be included in the primary beneficiary's gross estate for estate tax purposes (and generation-skipping transfer tax purposes) while avoiding Medicaid eligibility issues and estate recovery. For example, consider the application and utilization of IRC § 2041(a)(3) ("the Delaware tax trap"). If the trust is drafted so that trust assets will be included in the primary beneficiary's gross estate for estate tax purposes and the settlor survives, the settlor will be deemed to have made a completed gift for gift tax purposes to the primary beneficiary upon the primary beneficiary's death if there was no completed gift upon the settlor's initial transfer to the trust. See IRC § 2511.