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CPA's guide to sophisticated estate planning techniques

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A CPA's Guide to Sophisticated Estate Planning Techniques

AICPA

American Institute of Certified Public Accountants

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David Thomas, III, Esq.
Margaret L. Toal, Esq.

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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FOREWORD

This book, based on the course, *Sophisticated Estate Planning Techniques* provides practical information for accountants who assist their clients with their estate plans. It is designed for the experienced practitioner and emphasizes the integration of their clients' multi-faceted situations so that they can take advantage of the available planning tools.

David Thomas, III, Esq. of Sherman & Howard, Denver, CO and Margaret L. Toal, Esq. of Hutchinson Black and Cook, Boulder, CO, have written an informative and practical book.

Linda Prentice Cohen, Publisher
Professional Publications and Technology Products

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CHAPTER 1

PLANNING WITH APPLICABLE CREDIT AMOUNTS

INTRODUCTION

The federal estate tax is a tax imposed on the transfer of the taxable estate of every person who is a citizen or resident of the United States at death. See Table A, page 10, for tax rates.

DEFINITION OF ESTATE

GENERAL DEFINITION

The estate tax is imposed not only on the amount of the taxable estate, but also on the amount of adjusted taxable gifts which have been made during lifetime (IRC §2001). Adjusted taxable gifts are gifts made by the decedent after December 31, 1976, and are included in the gross estate of the decedent.

The tax is imposed after the application of the **unified credit**. The credit permits a person to transfer a certain amount of property to persons free of federal estate tax. Under the Taxpayer Relief Act of 1997, the amount of the unified credit is being increased in steps each year (see Table B, page 11). The unified credit is applied both to adjusted taxable gifts which are made during lifetime and the taxable estate which passes at death.

The liability for the payment of the estate tax is imposed upon the executor (also known as the personal representative in many states) or administrator of the estate (§2002).

The taxable estate for estate tax purposes includes:

- Assets which are titled in the decedent's name,
- Retirement plan benefits,
- Life insurance, and

- Other interests which are less well-known as being taxable in an estate, including:
    - Revocable transfers,
    - Transfers with a retained interest,
    - Joint tenancy property,
    - Community property,
    - Property subject to a general power of appointment, and
    - Certain transfers of interests made within three years of death.

REVOCABLE TRANSFERS

If on the date of death the decedent alone, or with another person, had the power to alter, amend, revoke or terminate a transfer of property, then that property is included in the gross estate of the decedent-transferor for estate tax purposes. Also part of the gross estate is any such power which is relinquished within three years of the decedent's death (§2038).

The rules on revocable transfers are one reason that property placed in a revocable living trust, for example, is included in the decedent's estate.

TRANSFERS WITH RETAINED INTERESTS

The gross estate includes the value of all property (to the extent of an interest of the decedent in the property) of which the decedent has made a transfer by trust or otherwise and in which the decedent kept a life estate, an interest for any period which is not ascertainable without reference to death, or an interest for any period which does not in fact end before death.

The interest may be for the possession or enjoyment of, or right to, income from the property, or the right, either alone, or with another person, to designate the persons who shall possess or enjoy the property or the income. Keeping the right to vote directly or indirectly the shares of stock of a controlled corporation is considered retention of enjoyment of transferred property.

Example 1-1:

- George "gives" 1,000 shares of General Motors stock to his daughter, Sally, but George keeps the right to receive the dividends each year. He may or may not actually receive the dividends.
- When George dies, the value of the General Motors stock will be included in his taxable estate (because he retained the right to income from the property).

Example 1-2:

- Hank transfers a $100,000 investment account into trust for his grandchildren. Hank is the trustee.
- The trust provides for the distribution of income and principal, in the trustee's discretion, for a grandchild's health, support, and education. Hank retains no right to income or principal. The transfer is irrevocable.
- When Hank dies, the trust estate will be included in Hank's taxable estate, because he retained the right to designate the persons who may possess or enjoy the property.

Example 1-3:

- Roberta transfers valuable paintings to her son, Malcolm.
- She makes the transfer of legal title by a valid bill of sale but keeps the paintings on the walls in her home.
- When Roberta dies, the paintings will be included in her taxable estate, because she retained the enjoyment of the property.

JOINT TENANCY PROPERTY

Property which is owned in joint tenancy is also included in the gross estate, at least to the extent of the interest of the decedent in the joint tenancy property.

Property held in joint tenancy passes automatically at death to the surviving joint tenant by law rather than by will. Contrast this type of ownership to property owned as tenants in common. A decedent's interest in property owned as a tenant in common does **not** pass automatically to the surviving tenant(s) but rather is subject to disposition under the decedent's will.

Except for property held in joint tenancy between spouses, the value of the joint tenancy property included in the gross estate of the decedent corresponds to the contribution of the decedent in the acquisition of the property if the executor can show that the property was not acquired entirely with consideration provided by the decedent or was acquired by the decedent and other joint owners by gift, devise, bequest or inheritance [§2040(a)].

Example 1-4:

- Three brothers buy a fishing lodge in joint tenancy, with Matty providing 40% of the consideration and Phillip and Jay 30% each.
- If Matty dies, 40% of the value of that property will be included in his gross estate.

Qualified Joint Interest

A qualified joint interest is any interest in property held by the decedent and the decedent's spouse as tenants by the entirety or joint tenants with right of survivorship, but only if the decedent and the spouse are the only joint tenants. If spouses own a qualified joint interest, then one-half of the value of the qualified joint interest property is included in the estate of the deceased joint tenant spouse (§2040).

GENERAL POWER OF APPOINTMENT

A power of appointment is an authority, usually granted to the beneficiary of a trust, to designate (or "appoint") which person(s) will be the successor beneficiaries — that is, who will receive the property on termination of the trust.

A **general** power of appointment is a power to appoint property which may be exercised by a person (the "holder" of the power) in favor of the holder himself, his estate, his creditors or the

creditors of his estate. Property which is subject to a general power of appointment is included in the taxable estate of the decedent(§2041).

Example 1-5:

- By his will, a husband established a Credit Shelter Trust for his wife, with her as trustee.
- If the trust provides that the wife may distribute (appoint) the principal to herself for her general welfare and happiness, then the wife is deemed to have a general power of appointment.
- Therefore, after the wife dies, the property in the Credit Shelter Trust will be part of her taxable estate.
- If, however, the wife's authority as trustee to make distributions of principal extended only to amounts for her health, education, support or maintenance, then the wife would **not** be deemed to have a general power of appointment.
- The distributions were subject to the ascertainable standard — health, education, support or maintenance — and the property in the Credit Shelter Trust would **not** be included in the wife's taxable estate at her death.

This is a very important distinction for estate planning purposes. Consider a Credit Shelter Trust established for a surviving spouse which permits the trustee to make principal distributions to that spouse. There are three key cases:

- If there is an independent trustee (not the wife) with the authority to make distributions to the wife for her general welfare and happiness (not limited by the ascertainable standard of health, education, support or maintenance), the property is not deemed subject to a general power of appointment and the property in the Credit Shelter Trust will not be subject to federal estate tax later in the wife's estate.
- If the wife is the trustee and has the authority to make distributions of principal to herself for her general welfare and happiness, then the wife is deemed to have a general power of appointment and the property in the Credit Shelter Trust will be included in the wife's taxable estate.
- If the wife is the trustee but distributions of principal are limited to health, education, support or maintenance, the wife is not deemed to have a general power of appointment and the property in the Credit Shelter Trust will not be included in the wife's taxable estate.

THREE YEAR RULE

Before 1981, gifts made within three years of the date of death were considered in "**contemplation of death**" and so were included in the decedent's taxable estate.

But now, gifts of $10,000 or less made before death are not included in the decedent's taxable estate (§2035). If a father makes gifts of $7,500 of cash to his children (and has made no prior gifts that year) and dies the next day, the $7,500 amounts are not part of his estate. Making pre-mortem gifts of up to $10,000 can be an effective estate planning strategy but there are exceptions.

Exceptions

The value of an insurance policy on the decedent's life is included in the decedent's estate if the gift of the policy was made by the decedent within three years of death. Transfers of interests are also included in the gross estate under §2036 (retained life estate), §2037 (transfers taking effect at death), or §2038 (revocable transfers).

Also, for purposes of determining the estate's eligibility for §303(b) distributions in redemption of stock to pay death taxes, special valuations under §2032(A) and installment payment of estate taxes under §6166, the three-year rule applies for certain purposes.

Taxable gifts can be an effective estate planning strategy. These gifts must be made, however, more than three years prior to the decedent's death. The amount of gift tax which is paid by the decedent or his estate on gifts made within three years of death is included in the gross estate whether or not the gift is includable in the gross estate, eliminating the incentive to make a deathbed transfer which would remove from the tax base the amount of the gift tax liability. This will be further discussed in Chapters 3 and 4.

COMMUNITY PROPERTY

One-half of community property is deemed owned by the decedent spouse and one-half by the surviving spouse, without regard to legal title. The decedent spouse is required to include one-half of the community property in the gross estate.

The rules can be complicated and vary by state. Nine states currently have community property laws: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. Several states have had them for brief periods of time. Many common law states provide that community property retains its character even when the owners move to another state (e.g., from California to Colorado). Later-acquired assets may be traced back to community property funds and may retain community property character.

However, many community property states allow spouses to sever community property into separate property or even change separate property into community property. The severance of community property is sometimes called "transmutation." Before 1982, the "transmutation" agreements often had gift tax consequences, but they now can qualify for the unlimited gift tax marital deduction. State law varies on the requirements for making these types of agreements effective, both as a prenuptial or as postnuptial agreements. A move from one state to another may require a modification of the agreement so that it is effective in the new state.

Even in states where transmutation agreements are allowed, some types of property, such as certain qualified retirement plans, cannot be changed simply by making the mutual agreement, but require specific forms to consent to certain payment or beneficiary options.

Example 1-6:

- A husband and wife were married in California, a community property state, and had no assets at the time of the marriage.
- During the marriage, the wife earns a substantial income and the husband none. Through those earnings there is an estate worth $2,000,000.
- All the assets — a residence, a mountain cabin, and an investment account — are in the wife's name.
- If the husband dies first, one-half of this property ($1,000,000) is considered the husband's interest in community property and is included in his estate for federal estate tax purposes, even though he does not have the legal title to the property.
- This is generally the rule in community property states.

VALUATION

GENERAL DEFINITION

The value of an asset is usually determined for estate tax purposes as of the date of death. Regulations govern the method of valuing:

- Stocks and bonds,
- Interests in businesses,

- Notes,
- Cash on hand or on deposit,
- Household and personal effects,
- Annuities,
- Interests for a term of years,
- Remainder or reversionary interests,
- Certain life insurance and annuity contracts, and
- Shares in open-ended investment companies.

Generally, value is the fair market value of the property as of the date of the decedent's death. The executor may elect to use the alternate valuation date, described below.

Fair Market Value

Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being forced to act, and both having reasonable knowledge of relevant facts. Specifically excluded is any valuation determined by a forced sale price or a sale in a market other than that in which the item most commonly sold to the public.

Property is not valued as assessed for local tax purposes unless it can be shown that that value represents the fair market value as of the applicable valuation date. Items held by the decedent for sale in the course of business generally are reflected in the value of the business.

ALTERNATE VALUATION

Assets of the gross estate may be valued on an alternate valuation date (§2032). If property is distributed, sold, exchanged or disposed of within six months of the decedent's death, the property may be valued as of the date of that transaction.

If the property has not been distributed, sold, exchanged or otherwise disposed of within six months after the decedent's death, the property may be valued as of the date six months after the decedent's death (when the alternate valuation date is elected).

The executor of the estate makes the election to use the alternate valuation date. **All** property must be valued as of the alternate valuation date. So, the executor may not value some assets as of the date of death and others as of the date six months after the date of death. Property which passes for purposes of the charitable deduction (§2055 or §2106(a)(2)) or the marital deduction (§2056) must be adjusted in value as of the date six months after the decedent's death or the date of sale, exchange or other disposition if the executor elects the alternate valuation date.

Form 706

The election of the alternate valuation date is made by the executor on the federal estate tax return (Form 706) and is irrevocable. The election is not allowed if the return is filed more than one year after its due date, including extensions. The election is not allowed unless it will result in lowering the value of the gross estate and consequently the federal estate tax.

Example 1-7:

- An estate is valued at the date of death at $900,000 and all passes under the will to the surviving spouse.
- If the assets are worth $1,100,000 six months after the date of death, the estate **may not** elect the alternate valuation date — to receive a step-up in basis for the assets to $1,100,000.
- There is no federal estate tax on the transfer to a surviving spouse under the unlimited marital deduction; the election of the alternate valuation date would not result in a decrease in the federal estate tax due.

FEDERAL ESTATE TAX RATES

The estate tax is paid with the filing of Form 706, the federal estate tax return. The tax is due nine months after the date of death. In certain cases, the executor may elect to pay the tax in installments under §6166. The rates are found in Table A.

TABLE A
Unified Rate Schedule

Column A Taxable amount over	Column B Taxable amount not over	Column C Tax on amount in Column A	Column D Rate of tax on excess over amount in Column A
			(Percent)
0	$10,000	0	18
$10,000	20,000	$1,800	20
20,000	40,000	3,800	22
40,000	60,000	8,200	24
60,000	80,000	13,000	26
80,000	100,000	18,200	28
100,000	150,000	23,800	30
150,000	250,000	38,800	32
250,000	500,000	70,800	34
500,000	750,000	155,800	37
750,000	1,000,000	248,300	39
1,000,000	1,250,000	345,800	41
1,250,000	1,500,000	448,300	43
1,500,000	2,000,000	555,800	45
2,000,000	2,500,000	780,800	49
2,500,000	3,000,000	1,025,800	53
3,000,000		1,290,000	55

For estates between $10 million and $21,040,000, there is a 5% surcharge.

APPLICABLE CREDIT AMOUNT

The unified credit is increasing each year, beginning in 1998 and ending in 2006. The applicable exemption amount corresponding to the increasing credit is set forth in Table B (§2010).

TABLE B

INCREASE IN APPLICABLE EXEMPTION AMOUNT (1997 STATUTORY CHANGE)	
1998	$625,000
1999	650,000
2000	675,000
2001	675,000
2002	700,000
2003	700,000
2004	850,000
2005	950,000
2006	1,000,000

MARITAL DEDUCTION

A deduction is allowed for the value of property which passes from the decedent to the decedent's surviving spouse (§2056). This marital deduction applies to gifts which are made outright from the decedent to the spouse, as well as to certain interests transferred in trust for the benefit of the spouse during the spouse's lifetime. If the spouse is a U.S. citizen and the interest qualifies as a deductible interest, the marital deduction is an unlimited deduction. Before 1981, the marital deduction was limited to one-half of the decedent's estate or $250,000, whichever was larger.

OTHER DEDUCTIONS – CREDITS

ADMINISTRATIVE EXPENSES

Administrative expenses are a deduction for purposes of determining the amount of the taxable estate (§2053). The executor has the choice whether to take these deductions on the decedent's income tax return or on the federal estate tax return (see §642(g)).

Expenses incurred in connection with the funeral and burial are deductible and include such items as the casket, burial vault, clothing purchased for burial, flowers provided by the estate, and the

cost of transporting the body to the place of burial. Tombstone monuments and mausoleum burial plots are also deductible. The expenses are limited by a test of reasonableness and whether or not they are properly allowable out of the probate estate under state law. Generally, the expenses must have been paid from the decedent's estate.

Other deductible administrative expenses are the executor's commissions, attorney's and accountant's fees for the estate, and other expenses incurred in the collection of assets, payment of debts, and distribution of property to the persons entitled to it from the estate.

DEBTS

The estate may deduct from the taxable estate claims which were personal obligations of the decedent that were enforceable against the decedent at the time of death. It may also include contingent claims against the decedent if there is a possibility that the liability will actually arise. In general, taxes are deductible in the estate to the extent that they were an enforceable obligation against the decedent at the time of death.

Unpaid gift taxes on gifts made by the decedent before his death are deductible. (State death taxes and possibly some foreign taxes are credits against the federal estate tax.) Taxes on income earned by the decedent before death are deductible. This does not include income of the surviving spouse. Nor does it include taxes on income received after death. The estate may elect to treat state death taxes and some foreign taxes which are imposed upon charitable bequests as deductions.

CASUALTY LOSSES

The estate may deduct casualty losses incurred by the estate (§2054). Deductible casualties are defined by the type under §165(c).

STATE DEATH TAXES

The estate tax is credited with the amount of any estate, inheritance, legacy, or succession taxes actually paid to any state, which does not exceed the statutory amounts (§2011). The credit may not exceed the amount determined under table C (§2011(b)).

TABLE C
Computation of Maximum Credit for State Death Taxes
(Based on federal adjusted taxable estate)

(1) Adjusted taxable estate equal to or more than	(2) Adjusted taxable estate less than	(3) Credit on amount in column (1)	(4) Rate of credit on excess over amount in column (1)	(1) Adjusted taxable estate equal to or more than	(2) Adjusted taxable estate less than	(3) Credit on amount in column (1)	(4) Rate of credit on excess over amount in column (1)
			(Percent)				(Percent)
0	$40,000	0	None	2,040,000	2,540,000	106,800	8.0
$40,000	90,000	0	0.8	2,540,000	3,040,000	146,800	8.8
90,000	140,000	$400	1.6	3,040,000	3,540,000	190,800	9.6
140,000	240,000	1,200	2.4	3,540,000	4,040,000	238,800	10.4
240,000	440,000	3,600	3.2	4,040,000	5,040,000	290,800	11.2
440,000	640,000	10,000	4.0	5,040,000	6,040,000	402,800	12.0
640,000	840,000	18,000	4.8	6,040,000	7,040,000	522,800	12.8
840,000	1,040,000	27,600	5.6	7,040,000	8,040,000	650,800	13.6
1,040,000	1,540,000	38,800	6.4	8,040,000	9,040,000	786,800	14.4
1,540,000	2,040,000	70,800	7.2	9,040,000	10,040,00	930,900	15.2
				10,040,00		1,082,800	16.0

Many states impose a state estate tax which exactly equals the state death tax credit under the federal estate tax provisions. The effect is to allocate a fraction of the tax revenue to the state government and to reduce the amount paid to the federal government, without increasing the amount of total tax on the decedent's estate. A few states impose estate taxes which exceed the federal credit. Several cities collect a transfer tax at death.

CHARITABLE DEDUCTION

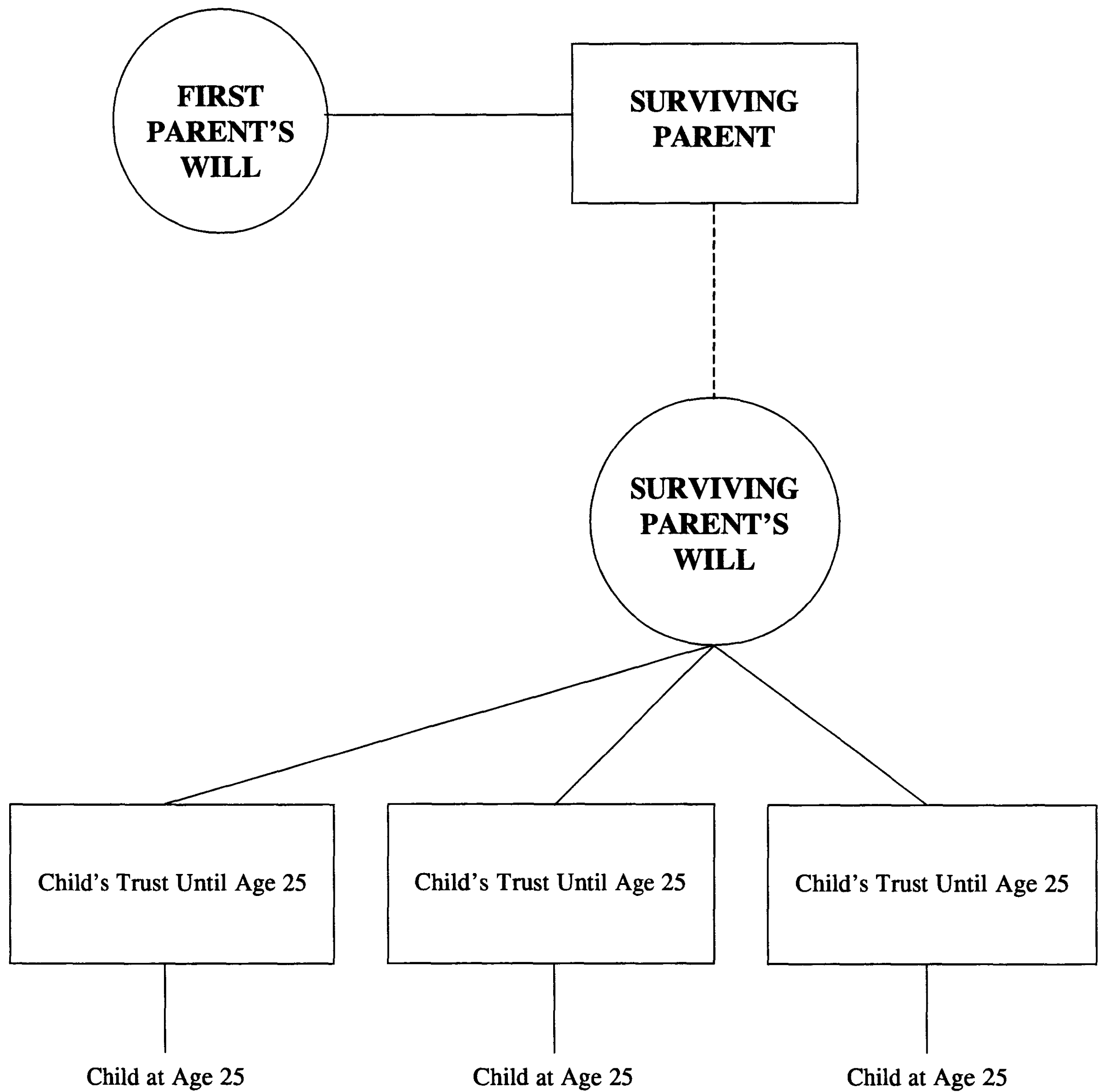
An unlimited charitable deduction for property passing to a qualified charitable organization is allowed against the estate tax (§2055). The value of all bequests, legacies, devisees, devices, or transfers to or for the use of the United States, any state, any political subdivision for exclusively public purposes or to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes is allowed as a deduction against the estate tax.

PLANNING WITH SIMPLE WILL

Consider a couple with two children. For a family with a moderate net worth ($250,000), traditional planning would suggest a simple will for the husband and a simple will for the wife.

The husband's will might provide, for example:

> *I leave my entire estate outright to my wife. If my wife does not survive me, I leave my entire estate in equal shares to my two children, with the share of any deceased child passing to such deceased child's issue. If a child of mine has not attained 25 years of age, such child's share shall be held in trust for such child's health, support, maintenance, and education under Article IV. My oldest living sibling shall be trustee of any such trust.*


FIRST PARENT'S WILL
SURVIVING PARENT
SURVIVING PARENT'S WILL
Child's Trust Until Age 25
Child's Trust Until Age 25
Child's Trust Until Age 25
Child at Age 25
Child at Age 25
Child at Age 25

From a federal estate tax point of view, if the wife survives, the property will pass to her shielded from estate taxes by the unlimited marital deduction.

If the wife does not survive, the property will pass to the children (possibly in trust) shielded by the applicable credit amount. If, in fact, the total estate is $250,000, the entire estate will be shielded from federal estate tax. This would be true even if the estate was equal to $650,000 (1999) or eventually $1 million (2006).

If the estate is larger, this simple will approach may result in a significant estate tax.

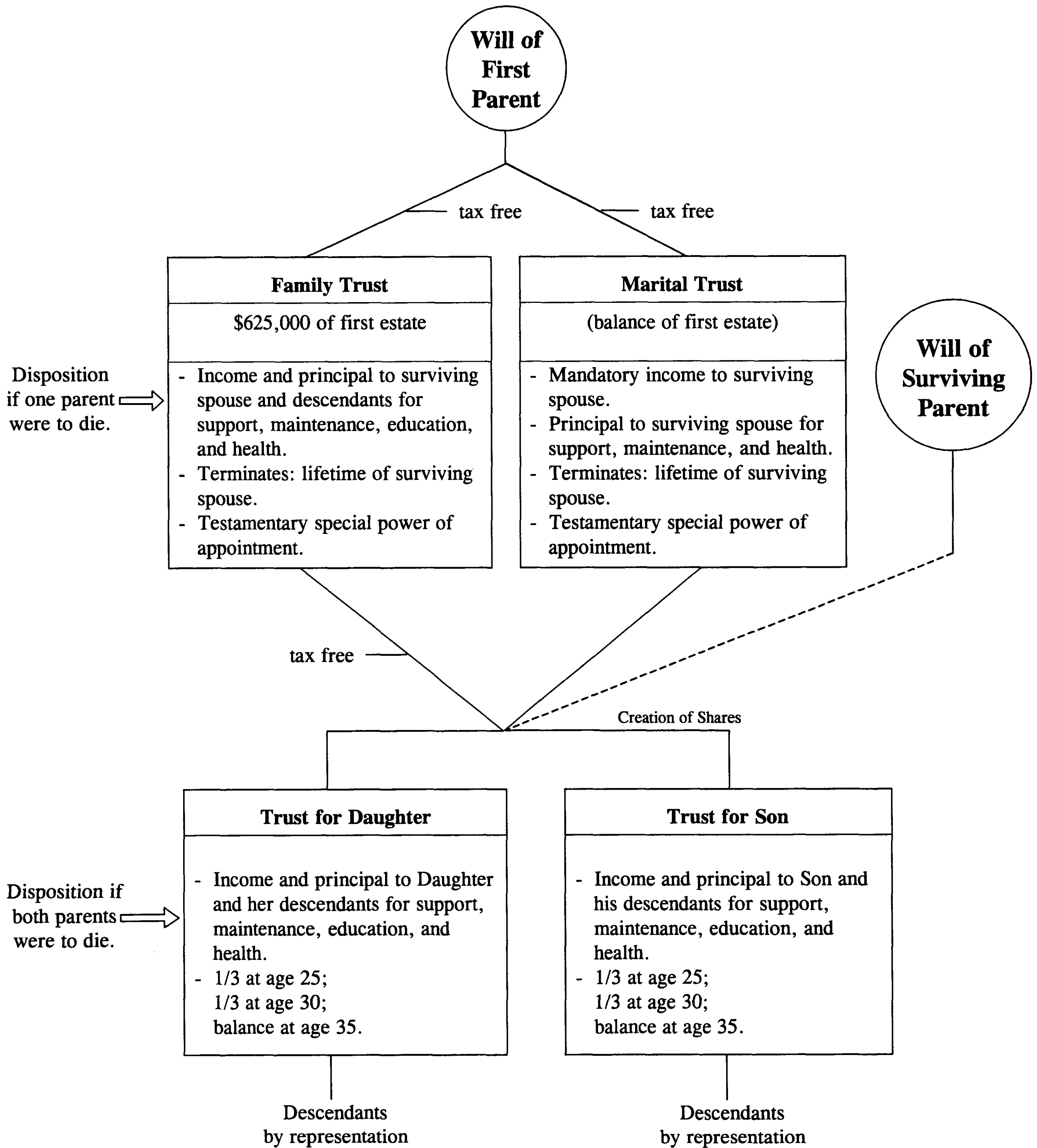
Example 1-8:

- Couple with an estate of $1,350,000 has simple wills.
- If the husband dies first, there will be no federal estate tax due (unlimited marital deduction).
- If the husband dies and the wife is not surviving, the $1,350,000 estate will be only partially shielded by the applicable credit amount.
- If the husband dies in 1999, the federal estate tax will be about $275,000 (on the taxable estate of $700,000).
- Even if the survivor dies in 2006 or thereafter, there will be an estate tax of around $135,000.

TRADITIONAL TAX PLANNING FOR MARRIED COUPLES WITH SUBSTANTIAL ESTATE

STANDARD APPROACH

For couples with larger estates (significantly over the applicable unified credit amount), the traditional recommendation is for husband and wife each to have a will which sets aside from the first estate the applicable credit amount. The applicable credit amount is usually distributed to a Credit Shelter Trust for the benefit of the surviving spouse and children.


Will of
First
Parent
tax free
tax free
Family Trust
$625,000 of first estate
- Income and principal to surviving spouse and descendants for support, maintenance, education, and health.
- Terminates: lifetime of surviving spouse.
- Testamentary special power of appointment.
Marital Trust
(balance of first estate)
- Mandatory income to surviving spouse.
- Principal to surviving spouse for support, maintenance, and health.
- Terminates: lifetime of surviving spouse.
- Testamentary special power of appointment.
Will of
Surviving
Parent
Disposition
if one parent
were to die.
tax free
Creation of Shares
Trust for Daughter
- Income and principal to Daughter and her descendants for support, maintenance, education, and health.
- 1/3 at age 25;
1/3 at age 30;
balance at age 35.
Trust for Son
- Income and principal to Son and his descendants for support, maintenance, education, and health.
- 1/3 at age 25;
1/3 at age 30;
balance at age 35.
Disposition if
both parents
were to die.
Descendants
by representation
Descendants
by representation

CREDIT SHELTER TRUST

Tax Purpose

From a federal estate tax perspective, the key is that the assets in the Credit Shelter Trust are not subject to federal estate tax in the estate of the surviving spouse. As explained below, the surviving spouse may have substantially full control and full benefit of the assets in the Credit Shelter Trust. The surviving spouse, in effect, may "have the cake and eat it too." The funds in the Credit Shelter Trust are fully available to the surviving spouse and family but eventually pass free of federal estate tax to the second generation.

Different Terms

The trust is referred to by several different terms:

- Credit Shelter Trust (because the trust is generally funded with an amount of property equal to the unified credit and eventually is sheltered from federal estate tax upon transfer to the second generation).
- Bypass Trust (because the remaining trust estate bypasses the taxable estate of the surviving spouse).
- Family Trust.
- Disclaimer Trust (because some planners structure the estate plan to fund the trust by way of a disclaimer by the surviving spouse).

This planning generally is often called marital deduction planning because the applicable credit amount is protected by transfer to a Credit Shelter Trust and the balance of the estate is shielded from federal estate tax by the unlimited marital deduction.

Funding

Example 1-9:

- Husband died with a will which set aside the applicable unified credit amount of $650,000 in 1999 into a Credit Shelter Trust for the benefit of the surviving spouse and family, with the balance outright to the surviving spouse.

(continued)

Example 1-9 (Continued):

- The husband's assets at the time of his death, all titled in his name, consisted of assets:

Residence	$ 250,000
Bonds	$ 350,000
Stocks	$ 400,000
Insurance Proceeds	$1,000,000

- The surviving wife may invest the insurance proceeds, building a diversified portfolio. Depending on her age, income needs, and risk aversion, the wife may invest the assets as follows:

Residence	$ 250,000
Rainy Day Fund (cash)	$ 50,000
Laddered Portfolio of Bonds	$ 600,000
Preferred Stocks	$ 650,000
Blue Chip Common Stocks	$ 400,000
Growth-Oriented Stocks	$ 350,000

- The assets included in the Credit Shelter Trust on the first death will pass free of estate tax upon the second death regardless of their later value.

- In deciding which assets to allocate to the Credit Shelter Trust, the executor or trustee should consider allocating the growth-oriented stocks and $300,000 of the blue chip stocks to the Credit Shelter Trust (in 1999). These assets may well increase in value during the wife's life.

- Indeed, if the $650,000 in the Credit Shelter Trust grows at historic rates of return for the wife's 20-year survivorship, the $650,000 may grow to $2,500,000. This entire trust estate of $2,500,000 in the Credit Shelter Trust would pass free of estate tax upon the wife's death to the children. That is, the usual approach would be to allocate to the Credit Shelter Trust the assets more likely to **appreciate** in value.

Income and Principal

As discussed earlier, if the surviving spouse is trustee of the Credit Shelter Trust, it is important that the distributions of principal be limited to health, support, maintenance, and education (so the surviving spouse will not be deemed to have a general power of appointment which would cause the assets remaining in the Credit Shelter Trust at the death of the surviving spouse to be included in the surviving spouse's taxable estate).

With this important exception, there are no other material limitations on the provisions which govern distributions of income and principal. The Credit Shelter Trust may provide, for example, for mandatory distributions of income to the surviving spouse and discretionary distributions of principal. Alternatively, and more commonly, the Credit Shelter Trust may provide:

> *The trustee shall distribute income and principal to my surviving spouse and to my descendants as the trustee may determine to be necessary or advisable to provide for the health, support, maintenance, and education of such respective beneficiaries.*

Testamentary Power of Appointment

Typically, the Credit Shelter Trust will continue for the life of the surviving spouse which may be an additional 20 to 30 years. Grandchildren may be born during that time and the personal and financial circumstances of the family may change greatly. Therefore, the surviving spouse is commonly granted a testamentary "special power of appointment" over the assets of the Credit Shelter Trust. This legal authority gives the surviving spouse the power, by his or her will, to allocate the trust estate remaining at death.

General Power of Appointment

If the surviving spouse has a **general** power of appointment, then the assets in the Credit Shelter Trust will be taxable in the estate of the surviving spouse. This clearly should be avoided. The surviving spouse has a general power of appointment if the surviving spouse has the authority to appoint the property to the surviving spouse, the surviving spouse's creditors, the surviving spouse's estate or the creditors of the surviving spouse's estate (§2041).

Limited or Special Power of Appointment

There may be granted to the surviving spouse a limited or special power of appointment, one which prohibits appointment of the property to the surviving spouse, the surviving spouse's creditors, the surviving spouse's estate, or the creditors of the surviving spouse's estate. This is an approach which gives the surviving spouse the flexibility by his/her will to allocate the remaining trust estate without causing the assets to be taxed in the survivor's estate. Subject to this limitation, there are three common approaches:

1. The majority of clients provide that the special power of appointment over the assets in the Credit Shelter Trust may be exercisable only in favor of the couple's descendants (children and grandchildren). The use (by the survivor) of such a special power of appointment may be illustrated by the following exercise under the will of the surviving spouse:

   > *I was granted a special power of appointment over the assets in the Credit Shelter Trust established by my husband at the time of his death. I have three children. I*

love my oldest child dearly but recognize that he has been very successful financially and has accumulated great personal wealth. Therefore, I exercise the special power of appointment to appoint the assets in the Credit Shelter Trust in equal shares to my two younger children, each of whom is a school teacher.

2. Some clients take the opposite extreme — not limiting the exercise of the special power of appointment to descendants but rather permitting appointment of the remaining trust estate to any person or persons (subject to the limitation of §2041). The surviving spouse may appoint the property to the new spouse, the next door neighbor, or an extremist group.

3. Other clients take a middle approach. The Credit Shelter Trust may provide:

   Upon the death of my spouse, my spouse shall have a special power of appointment exercisable by the will over the assets in the Credit Shelter Trust. The power of appointment shall be exercisable among my descendants, provided, however, that my spouse may appoint up to 33% of the assets to any person(s) chosen (other than my spouse, my spouse's creditors, my spouse's estate, and the creditors of my spouse's estate).

Credit Shelter Trust — Trustee

There are no substantial limitations on who may be the trustee of the Credit Shelter Trust. It may be the surviving spouse, or a bank, or an independent party, or an arrangement of co-trustees. If the surviving spouse is a spouse of a second or subsequent marriage, it is common to name co-trustees of the Credit Shelter Trust, as discussed below. If the surviving spouse is the spouse of the first marriage, then generally the surviving spouse is named as **sole** trustee of the Credit Shelter Trust.

As earlier noted, tax attributes are important in this regard:

1. If the surviving spouse is sole trustee of the Credit Shelter Trust, then distributions of principal must be limited to health, support, maintenance, and education. To reiterate, this is the so-called "ascertainable standard" (§2041).

If the surviving spouse is sole trustee of the Credit Shelter Trust and the Trust permits distributions of principal to the surviving spouse for "happiness" or "comfort" or "general welfare," then the surviving spouse is deemed to have a **general power of appointment** over the Credit Shelter Trust assets and the assets will be subject to federal estate tax in the estate of the surviving spouse. This limitation — that principal distributions be limited to health, support, maintenance, and education if the surviving spouse is trustee of the Credit Shelter Trust — is of critical importance.

2. From an income tax perspective, if the spouse has the legal authority as trustee to distribute the income to himself/herself, then the income will be taxable to the surviving spouse even though the income may be distributed to a different person. Assume the provision in the Credit Shelter Trust governing the distribution of income is as follows:

   The trustee may distribute the income to any one or more of the group consisting of my spouse and my descendants as the trustee may determine to be reasonable and appropriate.

With this provision, even if the surviving spouse distributes the income to the children, the income will be taxable to the surviving spouse who is also the trustee. (See generally §678.)

Additional Income Tax Consideration

If there is an independent trustee and if the Credit Shelter Trust makes no distribution of income, the income may be subject to tax as trust income on Form 1041. A trust reaches the highest federal income tax bracket at $8,100 of trust income. If the surviving spouse is in a lower income tax bracket, it may be advantageous to distribute the income to the surviving spouse (to shift the taxability of the income to the spouse's Form 1040 and to the lower bracket).

However, if the income tax bracket of the surviving spouse is the same as or higher than the Credit Shelter Trust, then it may be advantageous to accumulate the income in the Credit Shelter Trust. If there is no significant **income tax disadvantage** to accumulating the income in the Credit Shelter Trust, then there is an **estate tax advantage** to such accumulation.

If the income is distributed to the surviving spouse, then that net income (and future appreciation on that net income) will be subject to federal estate tax in the estate of the surviving spouse. If the net income is accumulated in the Credit Shelter Trust, the net income (and the future appreciation on that net income) will **escape federal estate taxation** in the estate of the surviving spouse.

Five-and-Five Power

As previously noted, §2041 provides that if the surviving spouse is the trustee, the surviving spouse will be deemed to have a general power of appointment (so that the assets of the Credit Shelter Trust will be subject to federal estate tax in the estate of the surviving spouse) if the spouse-trustee has the authority to distribute principal for purposes **broader than** health, support, maintenance, and education.

There is an exception to this rule (§2041). The surviving spouse may have the authority to withdraw principal from the Credit Shelter Trust in any calendar year, without being deemed to

have a general power of appointment, if this withdrawal right is limited to $5,000 or 5% of the value of the trust estate, whichever is greater. This is the so-called "five-and-five power."

Although this does add flexibility, if the surviving spouse has a right to withdraw principal equal to $5,000 or 5%, whichever is greater, then 5% of the assets of the Credit Shelter Trust will be **subject to federal estate tax** in the estate of the surviving spouse. If the assets in the Credit Shelter Trust have a value of $1 million at the death of the surviving spouse, then $50,000 of those assets are subject to federal estate tax, resulting in federal estate tax of $20,000 plus.

Many commentators believe, then, that including a "five-and-five power" in the provisions of the Credit Shelter Trust is unnecessary; indeed the inclusion of a five-and-five power is a **very expensive frill**. Typically, the surviving spouse has access to sufficient funds without including a "five-and-five power."

Available Funds

Typically, the surviving spouse has the access to the following funds:

1. Income of the Credit Shelter Trust;
2. Principal of the Credit Shelter Trust for health, support, maintenance, and education;
3. Income and principal from the Marital Trust or other marital assets;
4. Income (and often principal) from pension, retirement plan, and/or IRA; and
5. The surviving spouse's independent assets.

In general, then, one excellent tax-saving device for a couple is to **exclude** the "five-and-five power" from the provisions drafted in the Credit Shelter Trust.

MARITAL GIFT

TAX DESIGN

Generally the recommended structure is to allocate the applicable credit amount ($650,000 in 1999) to the Credit Shelter Trust and the balance to the surviving spouse. The funds passing to the surviving spouse are shielded from federal estate tax by the unlimited marital deduction. No tax is due.

Consider, for example, a husband with $1,900,000 of assets. The husband may have a will which provides for the set-aside into the Credit Shelter Trust of the applicable credit amount and the balance to the surviving spouse. In 1999, this would result in a distribution of $650,000 to the Credit Shelter Trust and the balance of $1,250,000 to the surviving wife.

NON-PROBATE ASSETS

Often, a significant share of the husband's property is so-called "non-probate assets." That is, many assets may pass independent of the will.

Example 1-10:

- Husband has $1,900,000 of assets:

IRA payable to wife	$400,000
Residence - joint tenancy	$250,000
Investment account - joint tenancy	$300,000
Investment account - personal	$800,000
Insurance payable to wife	$150,000

- In this example, $1,100,000 of assets will pass directly to the surviving wife as named beneficiary and as surviving joint tenant.

- The amount of $800,000 will be governed by the will. Of this amount, $650,000 (1999) will be allocated to the Credit Shelter Trust and the balance of $150,000 to the marital share.

MARITAL TRUST

To the extent the funds are governed by the will and are allocated to the marital share, the funds may be distributed to the surviving spouse **outright** or **in trust**. There are three types of marital trusts:

QTIP Trust

This is a trust which holds Qualifying Terminable Interest Property (that is, a property interest which terminates on the death of the surviving spouse but nevertheless qualifies for the marital deduction). This type of trust, called a QTIP trust, was introduced into the law in 1981. It is by far the most common type of marital trust to hold the marital share. A QTIP Trust has three essential requirements:

1. The QTIP Trust must provide the mandatory distribution of income to the surviving spouse for his/her whole lifetime (even if the surviving spouse remarries).

2. The surviving spouse must be the only beneficiary of income and principal.

3. Upon the eventual death of the surviving spouse, the remaining assets in the QTIP Trust will pass to the beneficiaries named by the first decedent (and not by the surviving spouse, unless the will grants the surviving spouse a testamentary special power of appointment, as noted below).

General Power of Appointment Trust

Prior to 1981, funds transferred to a Marital Trust for the surviving spouse qualified for the marital deduction only if the surviving spouse had a "general power of appointment" over the assets of the Marital Trust. That is, a marital deduction was permitted (so that no federal estate tax was due on the transfer of property from the decedent to the surviving spouse) only if the surviving spouse had the ability to "appoint" the Marital Trust to any person(s). The surviving spouse, for example, could appoint the remaining assets in the Marital Trust to the surviving spouse's new spouse.

Recall that the marital deduction prior to 1981 was **not** an **unlimited marital deduction**. Rather, the marital deduction was equal to $250,000 or one-half of the estate, whichever was greater. Therefore, classic marital deduction planning prior to 1981 had three attributes:

1. Distribution of one-half of the estate to the Marital Trust.
2. Marital Trust provided for mandatory distribution of income to the surviving spouse.
3. Marital Trust granted the surviving spouse a general power of appointment.

This classic structure may be seen in the will of John F. Kennedy which provided as follows:

> *I, JOHN F. KENNEDY, married, and residing in the City of Boston, Commonwealth of Massachusetts, being of sound and disposing mind and memory, and mindful of the uncertainty of life, do hereby make, publish and declare this to be my Last Will and Testament.*
>
> *FIFTH*
>
> *I hereby direct my Executors to divide into **two equal shares** all of the rest, residue and remainder of my property, real, personal, and of any nature whatsoever and wheresoever situate, of which I shall die seized and possessed, and to which I shall be entitled at the time of my death, including without limitation any gifts and bequests heretofore made by me which may fail or lapse, and any property over which I may have the right of testamentary disposition, and I hereby give, devise, bequeath and dispose of the said two equal shares as follows:*

[A] As to One of Such Equal Shares - (Hereinafter Called "The First Equal Share")

1. If my wife, JACQUELINE B. KENNEDY, survives me, then I give, devise and bequeath the ***First Equal Share*** *unto my Executors and Trustees hereinafter named, In* ***Trust****, nevertheless, for the benefit of my said wife, to invest, reinvest and keep the same invested, and to collect and receive the rent, income and profits therefrom, and after deducting all proper reserves and expenses,* ***to pay to my said wife, in each calendar year, all of the net income thereof****; such payments to be made in semi-annual or sooner installments, as my Trustees in their sole discretion may determine.*

2. Upon the death of my said wife, the Trustees shall pay over the principal of the trust as it shall then exist, to such person or persons, including her own estate, and ***in such proportions as my said wife designates or appoints in and by her Last Will and Testament, under and by specific reference to this paragraph.***

Estate Trust

Rarely used, a transfer of assets to an Estate Trust qualifies for the marital deduction. This trust does not require that mandatory income be distributed to the surviving spouse but requires that the remaining income and principal upon termination (that is, upon the death of the surviving spouse), be distributed to the estate of the surviving spouse.

MARITAL SHARE – SPECIAL CIRCUMSTANCES

TESTAMENTARY SPECIAL POWER OF APPOINTMENT

A QTIP Trust may grant to the surviving spouse a testamentary "special power of appointment." For example, consider a couple married for 30 years with three children and four grandchildren. The husband may grant to the wife a testamentary special power of appointment over the assets in the QTIP Trust as follows:

I grant to my wife a testamentary special power of appointment, exercisable among any one or more of our descendants. If my wife does not exercise such testamentary special power of appointment, then upon termination the remaining trust estate of the Marital Trust shall be distributed to my descendants, by representation.

Usually the form of the special power of appointment over the QTIP Trust is identical to the form of the special power of appointment over the Credit Shelter Trust. (See earlier discussion.)

Note that such a power of appointment in a QTIP Trust must be a **testamentary** special power of appointment. If the surviving spouse has a special power of appointment exercisable over the QTIP Trust during lifetime (or any other authority to distribute funds from the income or principal from the Marital Trust to anyone other than the surviving spouse), then the assets passing to the QTIP Trust will not qualify for the marital deduction.

NON-CITIZEN SPOUSES

The unlimited marital deduction is not allowed for property passing to a surviving spouse who is not a United States citizen. For property to pass free of federal estate tax to a surviving spouse who is not a U.S. citizen, the property must pass to a Qualified Domestic Trust (commonly called a QDOT).

QDOT

Historically, a QDOT is a trust which requires that at least one of the trustees be a U. S. citizen or a domestic corporation and that the trustee have the right to withhold taxes imposed under §2056A(b). The property remaining in the QDOT at the surviving spouse's death must be subject to estate tax.

Further, trust distributions to the surviving spouse during the surviving spouse's lifetime (except for income and hardship disbursements) must be subject to U.S. estate tax. This is a heavy financial burden for a surviving non-U.S. citizen spouse. The principal distributions from a QTIP trust to a U.S. citizen-spouse are not subject to estate tax. The principal distributions to a non-U.S. citizen-spouse from a QDOT are subject to estate tax.

There is no requirement to provide for all trust income to be paid annually to the surviving spouse as there is with the Power of Appointment Trusts and QTIP trusts. The U.S. trustee requirement has been modified by the Taxpayer Relief Act of 1997 in certain situations. The executor of the decedent's estate must make an irrevocable election on the federal estate tax return to treat a trust as a QDOT. There are strict security requirements on QDOTs which contain assets in excess of $2 million and there is a two-tiered structure which is imposed in order to assure that the §2056A tax is collected.

If there is value exceeding $2 million, determined without regard to indebtedness on the assets, the trust document must require that at least one trustee be a U.S. bank or the U.S. branch of a foreign bank or that the U.S. trustee furnish a bond in favor of the IRS or a Letter of Credit in an amount equal to 65% of the fair market value of the trust assets, again determined without regard to indebtedness. Also, the investment in offshore real estate may be limited in a QDOT. Value is determined as it would be for federal estate tax purposes.

QUALIFIED PLAN ASSETS

Often a substantial part of an individual's estate consists of funds held in a qualified retirement plan, profit-sharing plan, 401(k) plan, or IRA. If the qualified retirement plan asset is allocated to the surviving spouse, it will qualify for "rollover" treatment so that no income tax will be due.

However, if the qualified retirement plan asset is allocated to the Credit Shelter Trust, the transfer from the decedent's estate to the Credit Shelter Trust will be considered a "distribution" and will trigger income tax. The qualified retirement plan asset may raise particular difficulties in two situations:

Retirement Plan — Large Portion of Estate

Example 1-11:

- Husband has an estate consisting of the following assets:

401(k)	$ 850,000
50% interest in residence	100,000
Life insurance	200,000
Investment assets	50,000

- Generally, the husband would be well-served to have a will which provides for a set-aside of the applicable credit amount to a Credit Shelter Trust and the balance to the surviving spouse.
- Assume the husband has such a will, with the marital share passing outright to the surviving spouse.
- If the husband dies in 1999, the ideal would be to transfer $650,000 to the Credit Shelter Trust. However, the husband has only $350,000, independent of the 401(k) plan, which may be allocated to the Credit Shelter Trust.

Avoiding Taxes

If the beneficiary designation is such that $300,000 of the 401(k) plan is distributed to the Credit Shelter Trust — to fully use the $650,000 applicable credit amount — then there will be **income tax** due on the $300,000 distribution. Better planning would suggest allocating only $350,000 to the Credit Shelter Trust and distributing the entire $850,000 of 401(k) plan assets to the surviving spouse (qualifying for a spousal rollover and postponing the **income tax**). This solution constitutes

a trade-off — the benefit of deferring income tax at the husband's death achieved at the cost of a greater **federal estate tax** at the surviving wife's later death.

Obviously, it is not possible to know whether the husband or the wife may die first. In a situation, however, in which the husband may be significantly older and perhaps in poor health, it may be advisable to transfer assets from the wife to the husband — to build up his estate so that he can better utilize his applicable credit amount assuming he dies first.

There is no perfect solution, and this is a relatively common planning dilemma. It is often the case that a husband dies first with most of his assets in a qualified retirement plan. The husband may be able to use only a fraction of his applicable credit amount, even though his total estate may be substantially more than the applicable credit amount.

Children From Prior Marriage

Consider the above example and assume the husband has two children, both from a prior marriage. The most simple way to qualify for the marital deduction (for federal estate tax purposes) and for the spousal rollover (for income tax purposes) is to provide that the $850,000 in the 401(k) plan will be paid outright to the surviving spouse. If these funds are paid outright to the surviving wife, she will have the ability later to transfer the funds to her family or to her new husband or to a third party.

In this example, the husband may wish to transfer the $850,000 of assets in the 401(k) plan to the surviving wife in a QTIP Trust — to provide benefit to the surviving wife, but to assure that any balance remaining at the wife's death will pass to his children from a prior marriage.

Historically, for a QTIP Trust to also qualify for a spousal rollover of qualified retirement plan funds, the QTIP Trust had to be established as an **irrevocable trust** during the lifetime of the husband. The husband was not required to make an irrevocable beneficiary designation, but he was required to establish an irrevocable QTIP Trust during his lifetime as the "vessel" for the eventual distribution of the 401(k) funds.

Given these requirements, the husband's estate plan often consisted of a will which provided for the set-aside of the applicable credit amount into a Credit Shelter Trust and the balance of the funds (other than the qualified retirement plan) to a QTIP Trust. The husband then established a separate irrevocable QTIP Trust as the vessel to receive the qualified retirement plan funds.

Proposed Regulations

As of this writing, the IRS has proposed modified regulations to §401(a)(9) which would require that the QTIP Trust (to qualify as a spousal rollover vessel for qualified retirement plan benefits) be irrevocable as of the participant's death (the husband's death), rather than prior to death.

This issue should be monitored. It will probably remain the case, though, that for a husband (or wife) with children from a prior marriage and with a substantial portion of the estate consisting of a qualified retirement plan, the husband may want to structure the estate plan so that the qualified retirement plan benefits are distributed to a QTIP Trust. To reiterate, this QTIP Trust would be structured to qualify for the unlimited marital deduction under the federal estate tax and for a spousal rollover under the income tax.

SPOUSE WITH MODEST ASSETS

Consider, for example, a husband with an estate of $4,000,000, most of which consists of stock and family business. Assume that the husband has three children from a prior marriage and that the husband and the wife each have been married twice before. Assume that the wife has essentially no assets.

If the wife were to die first, it would be preferable to take advantage of the wife's applicable credit amount. Indeed, if the wife were to die (first) in 2006 or thereafter, the wife would have an applicable credit amount of $1,000,000. If the wife had no assets, the family would lose the benefit of the $1,000,000 applicable credit amount.

If it were the first and only marriage for the couple, and if they had a long and solid marriage, then the husband might simply transfer $1,000,000 of assets outright to his wife. In this example, however, the husband may have reservations about making an outright transfer (because in most states this property would become the "separate property" of the wife for domestic relations purposes).

Therefore, the husband may have several goals:

- To transfer $1,000,000 to the wife in order take advantage of her $1,000,000 unified credit if she were the first to die.
- To position the assets so that the assets would eventually pass to the husband's children from a prior marriage.

To accomplish these goals, the mainstream approach is to establish a **lifetime QTIP Trust** for the wife and to transfer $1,000,000 (in 2006) into that trust. Husband establishes a QTIP Trust for his wife, by way of an inter-vivos gift, which provides as follows:

> *I hereby establish a QTIP Trust for my wife. The trust shall distribute the income to my wife in convenient installments, at least quarterly. The trustee shall make no principal distribution to my wife. Upon my wife's death, if I am then living, the trustee shall distribute income and principal to me for my health, support, maintenance, and education. Upon the death of the survivor of my wife and me, the trustee shall distribute the remaining trust estate to my children in equal shares.*

This lifetime QTIP Trust is oversimplified. It does, however, illustrate the basic planning technique — to transfer funds to a spouse in a form to use the spouse's applicable credit amount (if the spouse dies first) and to preserve the assets for the descendants of the donor-spouse. The gift to the lifetime QTIP Trust qualifies for the marital deduction and so no federal gift tax is due. Upon the wife's death, the QTIP assets are included in her estate and thus take advantage of her applicable credit amount.

LARGE ESTATE

ALLOCATION OF APPLICABLE AMOUNT

Example 1-12:

- 55-year-old couple with two children and a net worth of $1,300,000.
- If the husband dies in 2003, his will may set aside $700,000 to the Credit Shelter Trust and $600,000 to the QTIP Trust for the surviving wife.
- Given the surviving wife's substantial life expectancy, the full $1,300,000 may be needed by the wife to provide for her long-term financial independence and well-being.
- If the husband allocated the applicable credit amount to the children, it would leave the wife with only $600,000 of assets for her period of survivorship. This probably does not represent sound planning.

Example 1-13:

- 55-year-old couple with two children and an estate of $4,300,000.
- In this circumstance, it may be advisable for the husband to allocate the applicable credit amount ($700,000 in 2003) to the children (probably in trust).
- With this allocation, there would still be $3,600,000 passing to the Marital Trust which, presumably, would represent more than enough to provide for the surviving spouse's long-term financial independence and well-being.

Inheritance to the Children

For a large estate, then, consider allocating the applicable credit amount to the children (**and not to the Credit Shelter Trust**). Such an allocation may provide an immediate and spendable inheritance to the children prior to the death of the surviving spouse. Given the longer life expectancies in today's world, the surviving spouse may live to be 90. If that is the case, and if the applicable credit amount is allocated to the Credit Shelter Trust for the surviving spouse, the children may not receive any inheritance until the children are in their 60's.

For the larger estate, the parents can "afford" to allocate the applicable credit amount from the first estate to the children (and still protect the long-term financial security of the surviving spouse.) If the children are young, the applicable credit amount may be allocated to trusts for their benefit (possibly with the surviving spouse as trustee.)

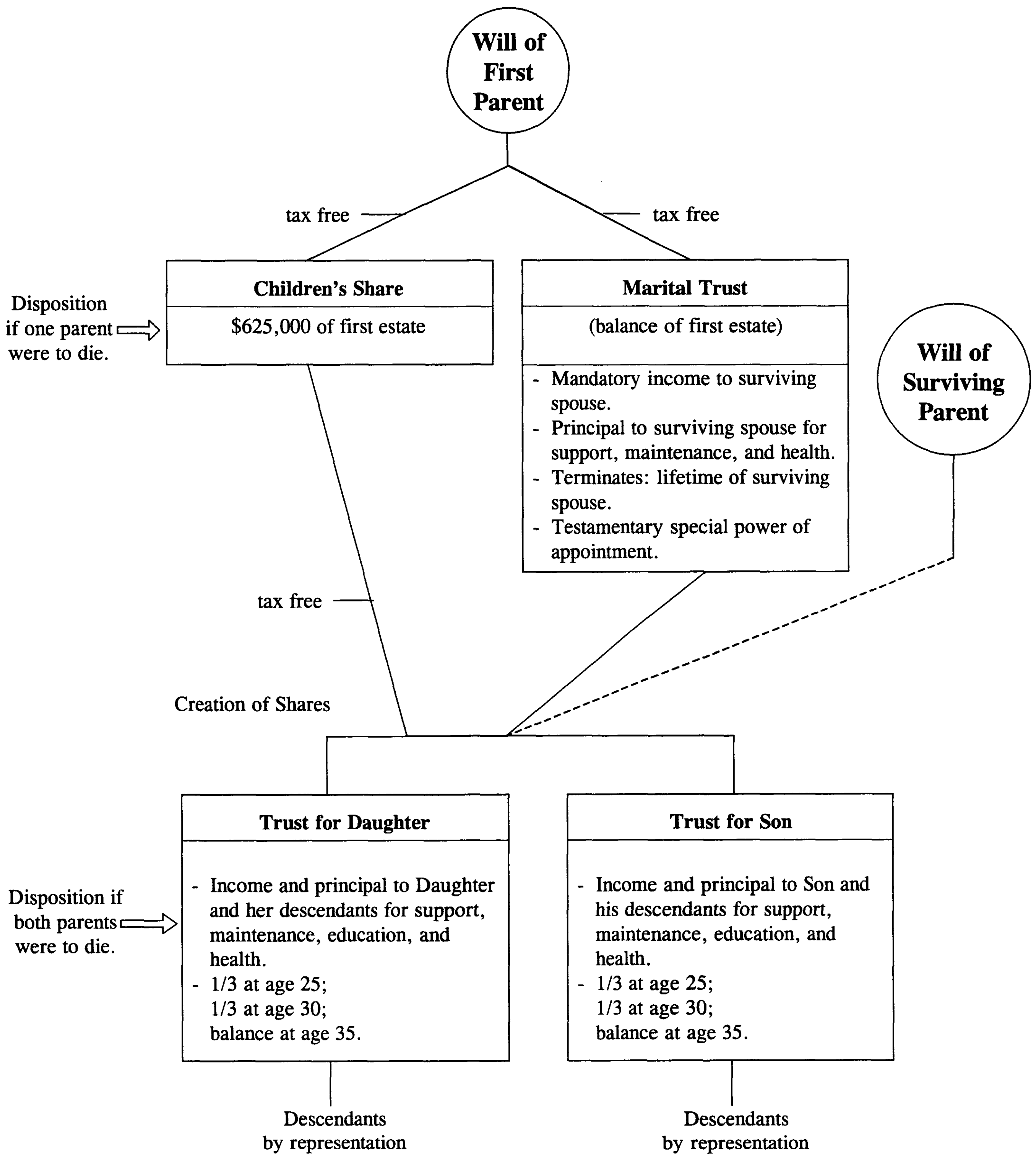
SECOND MARRIAGE

This strategy — allocating the applicable credit amount to the children — may also apply in the circumstance of a second marriage, particularly where the estate is larger. Consider a husband married to his second wife, with three children from a first marriage and an estate of $2,675,000. If the husband follows a "normal course," his will may allocate the applicable credit amount ($675,000 in 2000) to the Credit Shelter Trust for the benefit of the surviving spouse and the balance of $2,000,000 to a QTIP Trust for the surviving spouse.

In this circumstance, the children (of the first marriage) may receive no meaningful inheritance from their father until the death of the second wife. In some instances, the second wife may not be much older than the children of the first marriage. Given these circumstances, consider the allocation of the applicable credit amount to trusts for the children of the first marriage, with the balance of the estate passing to a QTIP Trust for the second wife. That is, the husband's will may provide that the applicable credit amount of $675,000 will pass in trust for the three children of the first marriage and the balance of $2,000,000 will pass to a QTIP Trust for the surviving spouse.

This strategy ensures that there will be no federal estate tax due on the first estate, that the children
from the first marriage will receive an inheritance, and that the surviving spouse will receive substantial funds for her benefit. Again, a husband in this situation can "afford" to allocate the applicable credit amount from the first estate to the children (and still protect the long-term financial security of the surviving wife).

Obviously, these decisions depend on the size of the estate, the personal and financial circumstances of the children and the second wife, and other factors. As will be shown in Chapter 5, this may be a circumstance where insurance planning (to increase the inheritance of the children from the prior marriage) can play an important role.


Will of First Parent
tax free
tax free
Children's Share
$625,000 of first estate
Marital Trust
(balance of first estate)
- Mandatory income to surviving spouse.
- Principal to surviving spouse for support, maintenance, and health.
- Terminates: lifetime of surviving spouse.
- Testamentary special power of appointment.
Disposition if one parent were to die.
Will of Surviving Parent
tax free
Creation of Shares
Trust for Daughter
- Income and principal to Daughter and her descendants for support, maintenance, education, and health.
- 1/3 at age 25; 1/3 at age 30; balance at age 35.
Trust for Son
- Income and principal to Son and his descendants for support, maintenance, education, and health.
- 1/3 at age 25; 1/3 at age 30; balance at age 35.
Disposition if both parents were to die.
Descendants by representation
Descendants by representation

TRUSTEE OF MARITAL TRUST

Consider a QTIP Marital Trust for a surviving spouse which provides for the mandatory distribution of income and the discretionary distribution of principal for health, support, and maintenance. From a legal perspective, the trustee is under a strict fiduciary duty to make sure that distributions of principal meet that standard. From a practical perspective, in most states there is **no meaningful regulation** or oversight of distributions of principal. Indeed, there is often no practical safeguard preventing the surviving spouse from withdrawing all of the principal from the QTIP Trust and spending the funds extravagantly.

To provide a practical safeguard for the funds, there are two situations in which the client may be well-advised to name **co-trustees** to oversee principal distributions from the QTIP Trust. These two circumstances are as follows:

Very Large Estate

Assume a 70-year old couple have three children and an estate of $10 million. If husband dies in 2006, there may be the allocation of the applicable credit amount to the children and the balance ($9,000,000 in 2006) passing to the QTIP Trust. Given that the surviving spouse may be failing in health, or subject to the influence of a smooth-talking scoundrel, or under pressure from a zealous charity, the substantial part of the family wealth in the QTIP Trust may be at risk if the surviving wife is the sole trustee of the QTIP Trust.

Children From Prior Marriage

Consider a couple where both have married previously. Assume the husband has three children from a prior marriage and no children from the current marriage. Assume the husband has an estate of $3,000,000. If the husband's will allocates the applicable credit amount of $1,000,000 in 2006 to the children in trust, there will be $2,000,000 in the QTIP Trust. That is, the majority of the husband's wealth will be in the QTIP Trust, presumably with the plan to be available to the surviving (second) spouse but with the goal that any funds remaining in the QTIP Trust at the death of the surviving spouse will pass to the children of the first marriage. Thus, two-thirds of the family wealth is in the QTIP Trust. Again, given the absence of practical safeguards, the substantial part of the family wealth may be at risk if the surviving (second) wife is the sole trustee of the QTIP Trust.

Three Common Approaches

In these circumstances, good planning may suggest an independent trustee or co-trustees of the QTIP Trust. There are at least three common approaches:

1. Name a bank or third party as independent (sole) trustee of the QTIP Trust.

2. Name as co-trustees the surviving spouse and an independent person.

I name as trustee of the QTIP Trust my surviving spouse and a person from the list below in the designated order:

My brother Jack
My sister Molly
My friend Nelson
My business partner Chris
My oldest daughter Jane

3. Alternatively, many clients choose to name as co-trustees of the QTIP Trust the surviving spouse and a person the surviving spouse **selects** from an "approved list." Again, the purpose of this planning is to provide a practical safeguard to preserve the principal in the QTIP Trust.

I name as trustee of the QTIP Trust my surviving spouse and a person selected by my wife from the list below.

My brother Jack
My sister Molly
My friend Nelson
My business partner Chris
My oldest daughter Jane

REVOCABLE TRUST (LIVING TRUST)

As previously noted, there are two common approaches in providing for the disposition of property. The estate plan may be embodied in a will only. The estate plan may be embodied in a will and a revocable living trust. This latter structure — a "two document structure" — is described below.

PROBATE AND PROBATE AVOIDANCE

States With Uniform Probate Code (UPC)

In states that have adopted the Uniform Probate Code (UPC), the probate system has been simplified and is generally much less expensive than in states which have not adopted the UPC. The "**probate**" of a will is:

- Presentation of the will to the court,
- Acceptance of the will,
- Appointment of the personal representative (or executor), and
- Approval of the distribution of assets.

The probate process is simple and economical in states which have adopted the UPC. It is typically accomplished by the filing of pre-printed forms without a hearing. Generally, then, probate avoidance is not an appropriate goal in an estate which has adopted the UPC.

States Without the UPC

In states without the UPC, it is often the case that probate may be lengthy and expensive. Then probate avoidance through use of a revocable living trust may be recommended. These states include, for example, California, New York, Massachusetts, and Connecticut. The client establishes a revocable living trust during lifetime.

In a state without the UPC, it is generally advisable to transfer the client's assets to the trust during lifetime — to "fund" the trust. When the client later dies, no (or little) property passes under the will of the decedent (because the property has previously been transferred to the revocable trust). Therefore, the property does not pass "through probate." There is avoidance of the delays, expense and hearings of the difficult probate process.

CONFIDENTIALITY

Whether or not someone lives in a state that has the UPC, the revocable trust is often recommended so that the client can maintain confidentiality about the disposition of assets upon death. A will becomes a matter of public record, but the revocable living trust document is not public. The only public information available in the case of a funded revocable trust at death would be a will which would essentially name the executor of the estate, guardians of minor children where that's appropriate, and a clause which "pours over" into the revocable living trust.

For example, Clause Seventh of President Eisenhower's will is such a "pourover."

> *SEVENTH: All the rest, residue and remainder of the property, both real and personal and wheresoever situate, of which I may die seized or possessed and to which I may be entitled at the time of my death, and all property over which I have power of appointment and disposition, which powers I hereby exercise in favor of my general Estate, I give, devise, and bequeath to the MERCANTILE-SAFE*

> *DEPOSIT AND TRUST COMPANY of Baltimore, Maryland, and JOHN S. D. EISENHOWER, and their successors, as Trustees, of a certain Indenture of Trust bearing date September 27, 1961, and as amended by Indenture dated May 5, 1965, between me, as Settlor, and said MERCANTILE-SAFE DEPOSIT AND TRUST COMPANY and JOHN S.D. EISENHOWER, as Trustees, as an addition to the principal of said Trust, to be held by said Trustees upon the trusts, terms and conditions set forth in said Indenture of Trust as amended.*

If the revocable living trust has been funded, there are no assets which are disclosed to the court because they are included within the trust rather than within the probate estate. Of course, to the extent that the revocable living trust is not funded, then the assets that have not been placed in the revocable living trust would generally be disclosed in inventories, accountings, etc., that are filed with the probate court and become public records in states without the UPC.

VEHICLE FOR MANAGEMENT OF PROPERTY

Another use for the revocable living trust is that the settlor of the trust is assisted with the management of property. The settlor of the trust may retain complete control of the assets during lifetime, but vest management of the property in a co-trustee if the settlor wishes to remain as trustee, or in someone else as sole trustee to manage the property.

The revocable living trust can serve as a focused and organized way for the property to be managed when the client owns property but has little management experience, little skill in this area, little interest, or other circumstances exist for which it is not advisable to retain the management of the property. Since the trustees can sign on behalf of the trust and hold legal title to the assets, the trustee has control over the assets and authority to deal with the assets consistent with the provisions of the trust agreement.

Durable Financial Power of Attorney

In contrast to a revocable living trust, another available vehicle for the management of property is the durable financial power of attorney. With the durable power of attorney, as allowed by state law, the person (principal) names someone else (agent) who has full power over financial affairs and the financial power over assets. The power is not terminated in the event of incompetency or disability, so it is "durable." It terminates upon the death of the grantor of the power, or when the person decides to terminate it. This is a useful device. It may be used in addition to, or even in place of, a trust. However, it is not always convenient to use because at times financial institutions or third parties are reluctant to recognize it.

Conservatorship

If there are no trusts or durable financial powers of attorney, and a person becomes incompetent to handle financial affairs, then a court proceeding may be initiated to name a conservator. The management process in a conservatorship is similar to the probate process.

Neutral for Tax Purposes

The revocable living trust is neutral for tax purposes. Because the settlor retains power to amend, revoke, name trustees, etc., the trust is treated as though the settlor is the legal title holder and owner for tax purposes. It is disregarded for tax purposes (§2038, §671).

Neutral for Creditor Purposes

In most states the fact that the settlor retains complete control over the assets in the revocable living trust means that the assets are not protected from the settlor's creditors either during lifetime or at death.

COORDINATION OF BENEFICIARY DESIGNATIONS

It has been suggested earlier, but should be reiterated, that the ownership of property and the beneficiary designations on life insurance and qualified retirement plans be coordinated with the estate plan. It is not enough that the "design" of the estate plan is done well and the documents (wills, revocable trusts, etc.) are well-drafted. The ownership of property and the beneficiary designations must be coordinated with the estate plan.

Life Insurance

Example 1-14:

- Husband had an estate which set aside the applicable credit amount into a Credit Shelter Trust and was made up of the following assets:

(continued)

Example 1-14 (Continued):

IRA payable to wife	$400,000
Residence - joint tenancy	$ 50,000
Investment account - joint tenancy	$ 40,000
Investment account - personal	$ 10,000
Insurance payable to wife	$750,000

- The wife was the first-named beneficiary on the life insurance. If the husband died in 2003, only $10,000 would pass to the Credit Shelter Trust. The Credit Shelter Trust would be "underfunded." There would not be full use of the husband's $700,000 applicable credit amount.
- It would be preferable for the husband to name as the first beneficiary the Estate of the Insured (or the revocable trust if the estate plan was embodied in a will and a revocable trust).
- This beneficiary designation would channel the insurance proceeds into the estate, making the $750,000 of insurance proceeds available to help fill the Credit Shelter Trust.
- Notably, if husband and wife both died, this beneficiary designation would channel the insurance proceeds into the estate plan and into the trusts for the children — to provide for the management of the property and possibly to accomplish generation-skipping goals.

QUALIFIED RETIREMENT PLAN

Generally the recommended beneficiary on a qualified retirement plan, 401K plan or IRA is the surviving spouse. This issue and the associated spousal rollover for income tax purposes — has been discussed earlier in this chapter.

The issue was specifically addressed in the context of a prior marriage and the advisability of transferring qualified retirement benefits to an irrevocable QTIP trust. In a more simple situation, it is important generally that the first beneficiary be the surviving spouse in order to qualify for favorable income tax treatment.

TITLE TO PROPERTY

This chapter has also discussed the importance of examining the ownership of property as part of the estate planning process. If a spouse has a will which provides for the set-aside of the applicable credit amount into a Credit Shelter Trust but has no property in his or her name, then almost certainly "underfunding" of the Credit Shelter Trust will occur. As noted, it is often advisable to do some balancing of the ownership of property.

The ideal would be if the husband and wife each had $1,000,000 of property in his or her name — to take advantage of the full applicable credit amount by 2006 **and** to take advantage of the $1,000,000 generation-skipping tax exemption. A couple with a $3,000,000 estate which is all in the husband's name may consider, for example, transferring $1,000,000 to the wife. This would make it possible to take advantage of the wife's applicable credit amount and $1,000,000 generation-skipping tax-exemption if the wife were to die first. These issues of coordination may be particularly important for the accountant to consider. The **estate planning attorney** may see a client only once in a ten- or fifteen- year period. The estate planning attorney may not be aware of the acquisition of new property, new insurance policies, and the establishment of qualified retirement plans.

The accountant will serve the client well if the accountant sensitizes the client to the importance of these ownership and beneficiary designation issues and "nudges" the client to update his will and estate plan to accommodate all the changes that may have occurred in this regard.

CHAPTER 2

PLANNING WITH THE FEDERAL GENERATION-SKIPPING TAX EXEMPTION

INTRODUCTION

A generation-skipping transfer is a transfer from the first generation (grandparent) to the third generation (grandchild) and is subject to two separate taxes — the federal estate tax and the federal generation-skipping transfer tax. (IRC §2601 et seq.)

BASIC TAX RULES

GENERATION-SKIPPING TRANSFER

The generation-skipping tax (GST) may be imposed on the following transfers:

Taxable Distribution

Grandfather establishes a trust for his son. The trust provides for the distribution of income to the son and the distribution of principal to the son and the son's children for health, support, maintenance, and education. The trustee makes a distribution of principal to the son's daughter (the granddaughter) for piano lessons. This transfer represents a **"taxable distribution."** It is a distribution to a **"skip person"** (the granddaughter, who is more than one generation below the transferor-grandfather). The tax shall be paid by the transferee (the granddaughter).

Taxable Termination

In the example above, the son dies and the property passes to his two children (the grandchildren). This represents a taxable termination. The tax shall be paid by the trustee.

Direct Skip

The grandfather makes a $50,000 outright cash gift to his granddaughter. The transfer is shielded from federal gift tax by application of part of his unified credit. Nevertheless, the transfer may be subject to federal generation-skipping tax as a **"direct skip"** (the direct transfer from generation one to generation three). The tax is paid by the transferor-grandfather.

A direct skip can be an outright transfer to a granddaughter or a transfer to a trust for the granddaughter (as long as there is no person in the second generation who is a beneficiary of the trust, that is, there is no "non-skip person" who is a beneficiary of the trust).

These taxable events trigger a tax liability:

Event	Tax paid by
Taxable distribution	transferee
Taxable termination	trustee
Direct Skip	transferor

SKIP PERSON

Under §2613, the term "skip person" means:

1. A natural person assigned to a generation which is two or more generations below the generation assignment of the transferor, or

2. A trust

    a. If all of the interests in such trust are held by skip persons, or

    b. If

        i. There is no person holding an interest in such trust, for example, a charity can be named a beneficiary; and

        ii. At no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person.

3. Deceased Parent

For purposes of determining whether any transfer is a generation-skipping transfer, if the middle generation individual is deceased at the time of the transfer, the generation assignment of any descendant of such individual shall be adjusted accordingly.

This means, for example, that if a transferor-grandfather has a deceased son who has three living children (the grandchildren), those grandchildren are not considered "skip persons" with respect to the grandfather-transferor and any transfer by the transferor-grandfather to any of those grandchildren shall not be considered a generation-skipping transfer subject to federal generation-skipping transfer tax.

Tax Rate

The applicable rate with respect to any generation-skipping transfer is the product of:

1. The maximum estate tax rate (55%), and

2. The inclusion ratio with respect to the transfer. (The inclusion ratio is the percentage of a trust or transfer which is not shielded by the exclusion and is subject to the federal generation-skipping transfer tax.)

$1 Million GST Exemption

Every individual is allowed a GST exemption of $1 million which may be allocated by the individual (or the executor) to any of the property. Beginning in 1999, the $1 million amount will be increased annually by a cost-of-living adjustment (and will be rounded to the lowest multiple of $10,000) (§2631(c)).

For 1999, the GST Exemption has been increased to $1,010,000. (Rev. Proc. 98-61)

Example 2-1:

- Grandfather transfers property with a value of $1,500,000 (net of federal estate tax) to a trust for his son. The trust provides for the distribution of income and principal to the son for his health, support, maintenance, and education. At the son's death, which will be a taxable termination, the remaining trust estate shall pass to the son's children (the grandchildren) in equal portions. Upon the transferor-grandfather's death, the executor allocates his $1 million GST exemption to the transfer. Therefore, the trust has an inclusion ratio of one-third. Upon the death of the son, the property in the trust is worth $2,400,000. There will be a generation-skipping tax on the transfer of $440,000 (namely, 55%, the highest federal estate tax bracket, times one-third, the inclusion ratio, times $2,400,000, the value of the trust assets).

REPORTING

The payment of any GST tax and the allocation of the $1 million GST exemption for inter vivos transfers is reported on a federal gift tax return (Form 709 Schedule R).

The payment of any GST tax and the allocation of the $1 million GST exemption for testamentary transfers is reported on a federal estate tax return (Form 706 Schedule R).

Note: If the allocation of the GST exemption to any property is made on a timely filed gift tax return, then the value of the property for purposes of the allocation of the GST exemption shall be its value at the date of transfer. However, if any allocation of the GST exemption is not made on a timely filed gift tax return, then the value of the transfer for generation-skipping transfer purposes shall be at the value of the property at the time the allocation is **filed** — that is, at the time the late federal gift tax return is filed (§2642(b)).

This presents us with possible planning opportunities. If the value of the property increases between the date of gift and the date of filing of the late gift tax return, an unnecessarily larger amount (than would be necessary if the gift tax return had been timely filed) of the $1 million GST exemption is usual.

However, if the property decreases in value (as when an insurance premium is paid to an irrevocable insurance trust but the cash surrender value of the policy at the time the late gift tax return is filed is less than the amount of the premium), a smaller amount of the GST exemption will be used.

ANNUAL EXCLUSION TRANSFERS

The taxpayer may exclude from what would otherwise be a taxable gift the first $10,000 of such gifts to any person-donee (§2503). An **outright** gift from a grandparent to a grandchild, which is a nontaxable gift by reason of the annual exclusion, is also nontaxable for GST tax purposes (§2642(c)).

Technically, the inclusion ratio is zero. However, if there is a transfer from a grandparent to a **trust for a grandchild**, even if the gift qualifies for protection from the gift tax by reason of the annual exclusion, the gift is shielded from GST **only** if the trust is structured so that:

- During the life of the grandchild, no portion of the principal or income of the trust may be distributed to or for the benefit of any person other than the grandchild, and

- If the trust does not terminate before the individual dies, the assets of the trusts will be included in the gross estate of such individual.

Taxable Transfers

This means that the following transfers **would** be subject to federal generation-skipping tax (subject to allocation of the $1 million GST exemption) even if such transfer qualifies for the $10,000 annual exclusion under the gift tax:

- A gift by a grandparent to a trust which provides "the trustee shall distribute income and principal to my grandchild and my grandchild's children (my great-grandchildren) for health, support and maintenance."
- A gift by a grandparent to a "pot trust" which provides "the trustee shall distribute income and principal for the education of my three grandchildren."

In both of these cases, the gifts may be shielded from the gift tax by the annual exclusion; however, they will be subject to GST at 55% (subject to the $1 million GST exemption) because there is more than one beneficiary of the trust (§2642(c)(2)).

TRADITIONAL PLAN

CREDIT SHELTER TRUST — QTIP TRUST

Chapter 1 describes a recommended estate plan for a couple with a net worth substantially in excess of the applicable credit amount. Consider a couple with two children (ages 32 and 34) and a net worth of $3,400,000. Typically, the husband's estate plan would provide for a set-aside of the applicable credit amount into a Credit Shelter Trust and the balance into a QTIP Trust. Of the $3,400,000 net worth, assume $2,400,000 of assets are in the husband's name and $1 million of assets are in the wife's name. If a parent were to die in 1999, the amount of $650,000 would be distributed to the Credit Shelter Trust and the balance ($1,950,000 or $350,000) would be distributed to the QTIP Trust for the surviving spouse.

Under this structure, if both parents were to die, the combined estates would pass to the two children in equal shares. The assets in the Credit Shelter Trust (including appreciation during the surviving spouse's period of survivorship) would pass free of estate tax to the children.

Further, the applicable credit amount in the surviving spouse's estate would pass free of federal estate tax in equal shares to the children. If the husband died in 1999 and the wife died in 2005, then a total of $1,600,000 (plus appreciation in the Credit Shelter Trust) would pass free of estate tax to the children, namely $650,000 from the Credit Shelter Trust and $950,000 from the surviving spouse's estate. If the total estate was $3,400,000, there would be approximately $1,800,000 subject to federal estate tax, resulting in federal estate tax of approximately $820,000.

This suggests, then, that there would be total federal estate tax on the transfer of property (at the second death) of approximately $820,000 and hence a net estate passing to the children of $2,580,000. Each child would inherit $1,290,000.

For many couples, the estate plan provides that the $1,290,000 will pass outright to the children. In this example, the children are of a reasonable age of maturity. For couples with younger children, the estate plan often provides that the $1,290,000 inheritance passes in a trust for the child, with one-third distributions at ages 25, 30, and 35. In this latter mode, a child has the entire inheritance in the child's name by age 35.

PLANNING DILEMMA

In the above example, the $1,290,000 inheritance passing to the two children, ages 32 and 34, will be part of the child's taxable estate. Upon the child's later death, if the child has a significant independent net worth, the entire $1,290,000 inherited from the parents may be subject to federal estate tax in the child's estate.

At rates of approximately 45%, this would suggest that the inheritance would generate $580,500 of federal estate tax in the child's estate. Of course, this may be a significant understatement of the tax. If the property appreciates in value, the $1,290,000 inheritance may have a substantially greater value when the child dies.

If the 32-year-old survives until age 72, the $1,290,000 inheritance appreciating at the indicated net annual rate of appreciation below would increase to the designated amount:

5.0%	$10,320,000
7.2%	$20,640,000
9.0%	$41,280,000

These increases reflect a central theme of the financial world — the power of compound interest. Even if the property does not appreciate in value, the $1,290,000 inheritance will produce approximately $580,000 of additional estate tax in the child's estate.

USE OF $1,000,000 GST EXEMPTION

As previously noted, each individual has a $1 million GST exemption. In this example, the two parents may structure their combined estate plan to capture and allocate their respective $1 million GST exemptions. This may be done so that the eventual $1,290,000 inheritance of each child is divided into a $1 million "exempt" amount and a $290,000 "nonexempt" amount.

CREATION OF EXEMPT TRUST

The common alternative is to provide that upon the death of the transferor, the $1,290,000 net inheritance is divided into an exempt amount of $1 million (the amount which is allocated to the $1 million GST exemption) and a non-exempt amount of $290,000. The $1 million amount is placed in an Exempt Trust. These funds may be available to the child as noted below.

From a federal tax perspective, the key is that the principal of the Exempt Trust is not subject to federal estate tax or federal generation-skipping tax in the child's estate. If this share of the inheritance had increased to $4 million during the child's lifetime, all $4 million would pass tax-free to the third generation.

Trust Structure

Trustee

Often there is an independent trustee until the child attains a designated age of maturity; "designated" does not necessarily mean age 18 or 21. The child may be the sole trustee and preserve the "exempt" nature of the trust. Even if the child is the sole trustee, the principal of the trust will pass tax-free to the third generation upon the child's death.

Income and Principal

Commonly the trust provides for the distribution of income and principal for the health, support, maintenance and education of the child and the child's children. From a practical perspective, the income and principal are liberally available to the family. From a federal estate tax perspective, the distribution of principal is subject to the "ascertainable standard" (as discussed later); therefore, the principal is not subject to federal estate tax in the child's estate.

Special Power of Appointment

Often there is a special power of appointment permitting the child, by will, to appoint the property ("sprinkle" the property) among descendants, or among descendants in some larger group. To avoid inclusion in the child's estate as general power of appointment, the power of appointment is not exercisable in favor of the child, the child's estate, the child's creditors, or the creditors of the child's estate (§2041).

NON-TAX ATTRIBUTES OF LIFETIME TRUST

There are a number of non-tax advantages which may attach to a trust which last for the lifetime of the child:

1. Property held in trust generally is protected from the creditors of the child (if the creditor is sued). In some states, this depends on whether the child is the sole trustee and whether the trust permits discretionary distributions of income and principal. Some families establish the lifetime trust with the child as the sole trustee. If the child is sued, the child may resign and appoint a successor independent trustee. In a number of states this is a successful approach for keeping the trust estate beyond the reach of the child's creditors.

2. Property held in trust may also be protected in the context of divorce. Property in trust generally retains its character as the beneficiary's "separate property." In most states, when property is distributed pursuant to a divorce, the property is first divided into "separate property" and "marital property." Each person's "separate property" is beyond the reach of the divorcing spouse. It is the "marital property" which is divided equitably.

Again, in some states, the characterization of property held in trust as "separate property" may depend on whether the child is the sole trustee and whether the trust permits discretionary distributions of income and principal. With proper planning, the lifetime trust can be a way to shield a child's inheritance from the reach of a divorcing spouse.

HISTORICAL NOTE

This strategy — transferring property to a trust for a child in order to shield the property from creditors and from divorce — is historically well-founded. When President Thomas Jefferson prepared his will, his daughter was married to a spendthrift, Thomas Mann Randolph, who was deeply in debt. The law at that time was that if Jefferson died and passed the property outright to his daughter, the property would "merge" with the son-in-law's property and become immediately available to satisfy the son-in-law's creditors. Therefore, to protect the family property, Thomas Jefferson's will provided as follows:

> *... I Thomas Jefferson of Monticello in Albemarle, being of sound mind and in my ordinary state of health, make my last will and testament in manner and form as follows ... Considering the insolvent state of the affairs of my friend & son in law Thomas Mann Randolph, and that what will remain of my property will be the only resource against the want in which his family would otherwise be left, it must be his wish, as it is my duty, to guard that resource against all liability for his debts, engagements or purposes whatsoever, and to preclude the rights, powers and authorities over it which might result to him by operation of law, and which might, independently of his will, bring it within the power of his creditors, I do hereby devise and bequeath all the residue of my property real and*

personal, ... to my grandson Thomas J. Randolph, & my friends Nicholas P. Trist, and Alexander Garrett & their heirs during the life of my sd. son in law Thomas M. Randolph, to be held & administered by them ***in trust*** *for the sole and separate use on behalf of my dear daughter Martha Randolph and her heirs, ... I have subscribed my name to each of them this 16th day of March one thousand eight hundred and twenty six.*

EXEMPT TRUST AND NON-EXEMPT TRUST

Because there may be non-tax advantages to maintaining property in trust, parents may provide that the ultimate inheritance of a child (if the inheritance is larger than the applicable GST exemption) may be held in two lifetime trusts for the child. One trust, which has property allocated part of the $1 million GST exemption and which has an inclusion ratio of zero, is the Exempt Trust. The second trust, made up of property without allocation of the GST exemption and has an inclusion ratio of one, is the Non-Exempt Trust.

In the example above, if there is a transfer of $1,290,000 (net of federal estate tax) to each of the children, there would be an Exempt Trust holding $1 million of property and a Non-Exempt Trust holding $290,000 of property (the alternative would be to have one Lifetime Trust with an inclusion ratio of approximately 3/13 - 290,000/1,290,000). In this example, both parents fully utilize their GST exemption.

Identical Provisions

Usually the Exempt Trust and the Non-Exempt Trust have identical provisions with respect to the distribution of income and principal. For example, the Exempt Trust and Non-Exempt Trust may provide:

> *The trustee shall distribute income and principal to my child and to my child's descendants as the trustee may determine to be necessary or advisable to provide for the beneficiary's health, support, maintenance and education.*

Different Provisions — Special Power of Appointment

As noted, the central planning approach is to ensure that the assets in the Exempt Trust are not subject to federal estate tax or federal generation-skipping tax when the child dies. Therefore, if the child has a special power of appointment over the assets of the Exempt Trust, it is a limited power (and not a general power of appointment under §2041).

With respect to the Non-Exempt Trust, however, there has been no allocation of the $1 million GST exemption. Upon the death of the child, the assets of the Non-Exempt Trust **will be** subject

to **either** the federal generation-skipping tax **or** the federal estate tax. The federal generation-skipping tax is imposed at the highest applicable rate of the federal estate tax.

Therefore, it is preferable that the assets in the Non-Exempt Trust be subject to the federal estate tax in the child's estate (because the child's other assets may be such that the applicable rate is not the highest 55% estate tax rate).

Therefore, it is advisable to give the child a **general** power of appointment over the assets in the Non-Exempt Trust — to ensure that the assets in the Non-Exempt Trust are subject to federal estate tax in the child's estate (and not subject to the federal generation-skipping tax which may be at a higher rate).

Bloodline Family

As noted elsewhere, a general power of appointment is a power of appointment exercisable in favor of the holder, the holder's estate, the holder's creditors, or the creditors of the holder's estate. Therefore, this power of appointment, with respect to assets in the Non-Exempt Trust, is often exercisable in favor of "the descendants of the transferor-grandparent (basically, the bloodline family) and the creditors of the child's estate."

By adding the creditors of the child's estate as a permissible appointee, the power of appointment becomes a general power of appointment (§2041) so that the assets in the Non-Exempt Trust are subject to federal estate tax (and not federal generation-skipping tax) in the child's estate. In a sense, this is the "narrowest" general power of appointment — it probably means that the assets will stay in the bloodline. Stated differently, the power of appointment does not give the child the power to appoint the property to a greedy in-law or live-in friend or an extremist group.

Investment Strategy

Since the assets in the Exempt Trust will not be subject to federal transfer tax upon the death of the child, it is generally sensible to allocate the **appreciating** assets to the Exempt Trust and the **non-appreciating** assets to the Non-Exempt Trust.

In the example above, assume the parent transferred $1,290,000 (net of federal estate tax) to a child — $1 million in the Exempt Trust and $290,000 in the Non-Exempt Trust. To the extent that the trustee (who may be the child) pursues a diversified investment strategy, the trustee would be better served to allocate the bonds and cash-equivalents to the Non-Exempt Trust and the growth stocks to the Exempt Trust.

As noted, if the $1 million in the Exempt Trust increased in value to $7 million during the child's lifetime, all $7 million would eventually pass to the child's children (or other beneficiaries) free of federal estate tax and free of federal generation-skipping tax.

First Estate

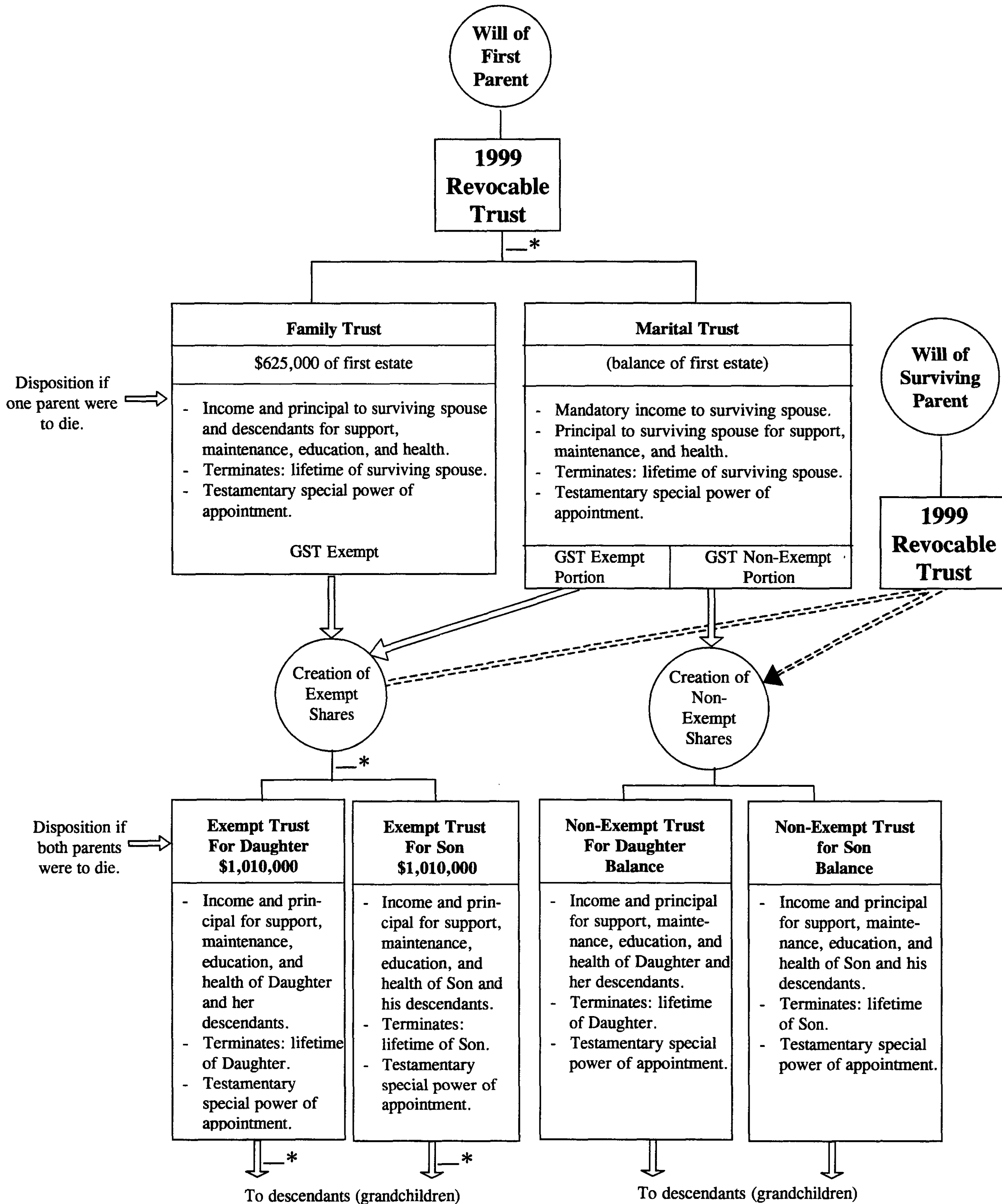
For parents who pursue this planning, the ideal is to use both $1 million GST exemptions of the parents. Assume the grandfather has a will which provides that the Unified Credit Amount ($650,00 in 1999 is allocated to the Credit Shelter Trust for the surviving spouse and that the balance of the first estate passes **outright** to the surviving spouse. With that approach, the family, in effect, "loses" $350,000 (in 1999 of the first parent's $1 million GST exemption. To capture the full $1 million GST exemption, the grandfather's will should provide, in effect:

> *I give the first $650,000 (in 1999) to the Credit Shelter Trust for my surviving spouse. My executor shall allocate $650,000 of my $1.01 million GST exemption to such transfer. I give $350,000 (in 1999) to an Exempt Marital Trust for my surviving spouse. My executor shall allocate the balance of my $1.01 million GST exemption to such Exempt Marital Trust.*
>
> *I give the balance of my estate outright to my surviving spouse.*

Although this is a simplified example, it demonstrates the basic approach in preserving the full $1 million GST exemption of the first spouse. Upon the surviving spouse's death, the surviving spouse may allocate the $1 million GST exemption so that the family will receive the full benefit of $2 million of GST exemption. Indeed, if the assets in the Credit Shelter Trust and the Exempt Marital Trust **appreciate in value** during the **lifetime of the surviving spouse**, then there is effectively an increase in the GST exemptions.

This planning is depicted schematically for a couple with two children. It assumes that the eventual inheritance passing to each child is $2,900,000 (net of federal estate tax). To maximize the benefits of generation-skipping planning, each child's inheritance is divided into an Exempt Trust (holding $1 million) and a Non-Exempt Trust (holding $290,000).

SCHEMATIC



*Tax-free distribution of property

SAFETY NET APPROACH

GENERAL CONCEPT

As noted above, generation-skipping planning can be accomplished with an Exempt Trust for a child. The funds in the Exempt Trust may generally be available to the child for health, support, maintenance, and education. The Exempt Trust is **not** a generation-skipping trust for **spending** purposes. The Exempt Trust **is** a generation-skipping trust for **federal transfer tax** purposes.

The child may be sole trustee of the Exempt Trust. However, some parents want to set aside a designated amount of funds to be managed by an independent trustee, often a bank trust department. The concern is that the child, acting as sole trustee of the lifetime trust, may squander the funds in poor investments or spend the funds on a greedy in-law. Therefore, the parents want to segregate a certain amount of the child's inheritance in the trust which will always have an independent trustee. The funds in this "Safety Net Trust" will always be available for the child's health and support.

SAMPLE APPROACH ONE

For some parents with larger estates, this "safety net idea" is integrated with the planning for the Exempt Trust and the Non-Exempt Trust. Consider a couple passing a $4,600,000 estate (net of federal estate tax) to two children. The parents may provide that each child's inheritance will be held in an Exempt Trust (holding $1 million) and a Non-Exempt Trust ($1,300,000). The parents may provide that a corporate trustee will always be the trustee of the Exempt Trust. The parents may provide that the child (upon attaining 35 years of age) will be the sole trustee of the Non-Exempt Trust. Even if the child spends or wastes the funds in the Non-Exempt Trust, the Exempt Trust represents a continuing "safety net" for the lifetime of the child. When the child dies, the funds in the Exempt Trust will pass free of federal tax to the third generation.

SAMPLE APPROACH TWO

Some parents with very large estates adopt the same general idea — the set-aside of a safety net — but use different fractions. Consider two parents who pass a total estate of $7 million (net of federal estate tax) to two minor children. Such parents may provide, for example, that each child's inheritance will be held in trust with an independent trustee until the child reaches 35 years of age. At age 35, the main trust will split into two equal portions, Fund A and Fund B. Fund A will be a continuing trust with the child as sole trustee. Fund B will be a continuing trust with an independent trustee. In an example like this, usually Fund B is divided in turn into an exempt portion and a non-exempt portion.

The point is that some parents with large estates do want to make sure that there is a substantial pool of resources preserved for the long-term financial security and well-being of the child, beyond the reach of the child's investment mistakes or a grasping spouse.

Sample Approach Three

Some grandparents take a slightly different approach in trying to make sure that funds are preserved for the health and education of the grandchildren. Consider two grandparents who have an estate of $3 million (net of federal estate tax), two children and five grandchildren. Some grandparents in this circumstance would provide as follows:

> *Upon the death of the survivor of the two of us, our ($3 million) net estate shall be divided as follows:*
>
> *20% into an Education Trust for our five grandchildren, and any future born grandchild, to be managed by an independent trustee. Part of our combined $2 million GST exemption shall be allocated to such transfers so that it shall not be subject to federal generation-skipping transfer tax.*
>
> *The balance of our estate shall be divided into equal portions for our two children. Each child's inheritance shall in turn be divided into an Exempt Trust and a Non-Exempt Trust.*

GIFT PROGRAM — GENERATION-SKIPPING TRUST

GENERAL CONCEPT

We will examine various strategies for making gifts to children and grandchildren in chapters 3 and 4. For larger estates, these gift ideas may include making large gifts using the applicable credit amount ($650,000 in 1999).

Example 2-2:

- Couple with a large estate owns a farm on the outskirts of a city which is in the path of development.
- The real estate, which currently has a value of $800,000, may increase substantially in value in the future. The couple considers giving an undivided 50% interest ($400,000) to each of their two children — to shift the value and the future appreciation out of the parents' estates.

Example 2-3:

- Couple with a large estate establishes a Family Discount Partnership (discussed later) and transfers $3 million of property to the partnership. The couple considers giving an undivided 15% interest to each of their two children — to shift the value and the future appreciation out of the parents' estates.

Example 2-4:

- Same facts as in Example 2-2, but the couple gives a $400,000 interest in the farm property to their 38-year-old daughter outright.
- Property is later developed into a shopping mall and the daughter's 50% undivided interest is worth $3 million at her death.
- The $3 million will presumably be included in the daughter's taxable estate, generating federal estate tax of approximately $1,500,000.

USE OF GENERATION-SKIPPING TRUST

What if the parents in the above examples made the gifts (the $400,000 of farm property or the interest in the Family Discount Partnership) to a generation-skipping trust for the child. For example, the parents may establish a trust for the daughter which provides as follows:

> *The trustee shall distribute income and principal to our daughter and the daughter's descendants as the trustee may deem necessary or advisable to provide for the health, support, maintenance and education of a beneficiary. The trust shall terminate upon the death of our daughter. Upon our daughter's death, she shall have a special power of appointment exercisable among our descendants. If our daughter does not exercise such special power of appointment, the trust estate remaining upon termination shall be distributed to her descendants, by representation. Our daughter shall be the sole trustee.*

Two Tax Steps

The parents could establish a trust of this sort and make the $400,000 gift to the trust taking two tax steps:

1. Shielding the transfer from federal gift tax by application of the unified credit.
2. Allocating $400,000 of the $1 million GST exemption (so that the trust would be "exempt" with an inclusion ratio of zero).

With this planning approach, the tax efficiency of the gift program would be greatly increased. Not only would there be significant tax saving on the transfer from generation one to generation two (from parents to daughter), there would also be significant federal tax saving upon the eventual transfer from generation two to generation three (from the daughter to her children).

For most sophisticated estate planners considering a program of large gifts for a client, the **starting presumption** is that the transfer to the child (or children) will be made in trust(s) exempt for federal generation-skipping transfer purposes. This can be very powerful planning. Some commentators would assert that a **large outright gift** to a child is 50% good planning and 50% mistake. The outright gift of appreciating property to the child represents good planning between generation one and generation two but a mistake with respect to the eventual transfer of the appreciated property from generation two to generation three.

ANNUAL EXCLUSION — COMPLICATION

This gift planning is quite complex when considering the $20,000 annual exclusion. Without highly technical planning, it is not possible for a donor to allocate $20,000 of GST exemption to a $20,000 annual exclusion gift. Nor is it likely that you would ever want to mix the annual exclusion with the GST exemption allocation in gifts to a trust; you want to keep the trust inclusion ratio "pure."

In the example above, assume the parents establish a trust for the daughter and transfer $400,000 of farm real estate. If the parents shield the entire $400,000 transfer from federal gift tax by application of the unified credit, then the parents can also allocate $400,000 of $1 million GST exemption so the trust has an inclusion ratio of zero (and is "pure" for generation-skipping tax purposes).

However, if the parents shield the $400,000 from federal gift tax by applying the $20,000 annual exclusion and $380,000 of unified credit, it is not possible for the parents to allocate a full $400,000 of GST exemption to the transfer. For technical reasons, the trust will have an inclusion ratio of greater than zero (the trust will not be "pure" for federal generation-skipping purposes). The idea — to maximize use of the $1.01 million GST exemption in a program of family gifts — is a sound and powerful estate planning concept but it must be done carefully.

IMPORTANT APPLICATIONS

SINGLE PARENT

Most of the illustrations in this chapter have been presented in the context of two parents preparing their estate plan. Obviously, this planning using the $1.01 million GST exemption (and an Exempt Trust for each child) can be an important tax-saving technique for a single parent.

Consider a single parent, Chris, with an estate of $1,800,000 (net of federal estate tax) and two children. The older child, Annie, is a securities lawyer and is married to an accountant. The younger child, Nick, is a third-year medical student with interests in surgery. This would be a classic circumstance in which the single parent might provide by will that the $900,000 inheritance of each child would be divided into an Exempt Trust (holding $500,000) and a Non-Exempt Trust (holding $400,000).

It is possible that at least one of the children might invest and reinvest the $500,000 in the Exempt Trust and never draw down the funds during lifetime. It is plausible that the $500,000 might increase to $2,500,000 during that lifetime. Annie and her husband, for example, might use their own earnings for purposes of raising the family and household expenses.

If single parent Chris transferred the $500,000 outright to Annie, then the eventual $2,500,000 would result in a federal estate tax of more than $1,200,000. By using part of her $1 million GST exemption and creating an Exempt Trust for each child, single parent Chris can make significant intergenerational federal tax savings.

PARENTS OF CLIENT

In many circumstances, the clients who are the focus of the planning situation are a middle-aged couple with significant assets and several children. It is proper to focus on the wills, trusts, gift programs, insurance trust, and generation-skipping trusts which may make it possible to reduce the federal estate tax and the federal generation-skipping tax on the transfer from the middle-aged couple to their children and grandchildren.

It is also important, however, to inquire about the financial circumstances of the **parents** of the couple. If the couple has a net worth of $3 million and if the wife is expected to inherit $750,000 from **her parents**, then the couple should be advised about the significant tax-saving advantages of the $1 million GST exemption.

Subject to family and "political" considerations, the wife may want to advise her parents to amend their estate plan — so that the wife's $750,000 inheritance will pass in an Exempt Trust for the wife. Following the mainstream approach, this Exempt Trust might provide that the wife would

be sole trustee, that income and principal distributions would be available to the wife and the family for health, support, maintenance and education, and that the wife would eventually have the flexibility to allocate the property by a testamentary special power of appointment. The transfer of the wife's $750,000 inheritance into an Exempt Trust for the wife would mean, of course, that these funds would not be added to the $3 million net worth of the client couple (and presumably eventually be subject to tax in their estates).

CHAPTER 3

GIFT STRATEGIES

INTRODUCTION

Since 1981, the federal gift tax system has been integrated with the estate tax system. Before that, they operated separately. The gift tax is effectively imposed at the same rates as the estate tax (IRC §2502(a)).

DEFINITION OF GIFT

A gift is a transfer of property from one individual to another individual, to a group of individuals or to a trust. Gratuitous transfers are taxable. Donative intent is not necessary so long as the transfer is complete and the donor has parted with dominion and control (§2511).

ANNUAL EXCLUSION AND QUALIFIED TRANSFER EXCLUSIONS

An individual may transfer up to $10,000 of present interest gifts to each donee in each calendar year without incurring a gift tax. A married person whose spouse consents may give twice the annual exclusion amount, currently $20,000 to each donee. Beginning in 1999, the $10,000 amount is increased by a cost-of-living adjustment and rounded to a multiple of $1,000 under the provisions of the Taxpayer Relief Act of 1997.

Also excluded from the transfer of property as a taxable gift is a "qualified transfer." A qualified transfer is an amount paid on behalf of an individual as tuition to an educational organization for the education or training of such individual, or to any person who provides medical care to such individual. These transfers must be made directly to the educational organization or to the person who provides medical care and not indirectly or in trust (§2503(e)).

Present Interest Requirement

Section 2503, in setting forth the annual exclusion, provides "... in the case of gifts (other than gifts of future interest in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such persons shall not ... be included in the total amount of gifts made during such year." To qualify for the $10,000 annual exclusion the transfer must be of a "present interest."

For example, a grandfather established a trust for his 7-year-old granddaughter that provided:

> *The trustee shall make no distribution of income or principal until my granddaughter, Molly, is a college undergraduate. At such time the trustee shall distribute the income and principal as the trustee may deem necessary or advisable to provide for the tuition, books, housing and other expenses related to Molly's undergraduate college education. Upon Molly's graduation from college, the remaining trust estate shall be distributed outright to Molly. If Molly does not graduate from college by the time she attains 25 years of age, the trust estate remaining at Molly's 25th birthday shall be distributed to Ohio State University.*

Without additional planning, if the grandfather makes a $10,000 gift to the trust, that gift will not qualify for the $10,000 annual exclusion. Instead the gift will potentially be subject to gift tax (or use part of the unified credit). The gift would not qualify for the annual exclusion because it does not constitute a "present interest" — Molly has no right to benefit from the trust property until she begins her undergraduate college education.

So, any gift intended as a $10,000 annual exclusion gift must be in a form which constitutes a "present interest" for purposes of §2503 of the federal gift tax.

Unified Credit

The unified credit was described previously in the estate tax discussion. The same unified credit, which is applied against the estate tax, is integrated with the gift tax provisions. The unified credit applies an exemption amount of $650,000 in 1999 which increases each year until topping off at $1 million in the year 2006. The unified credit may be used for transfers by gift during lifetime, or for transfers from the estate after death.

Marital Deduction

There is an unlimited marital deduction for gift tax purposes. If the donor transfers by gift an interest in property to a donee, who at the time of the gift is the donor's spouse, it will not be

included as a taxable gift (§2523(a)). The gift tax marital deduction is not available for gifts to a spouse who is not a U.S. citizen.

CHARITABLE DEDUCTION

For estate tax purposes, there is also an unlimited charitable deduction, in the case of a citizen or resident, of the amount of all gifts made to or for the use of the United States, any state, any political subdivision, or any qualified charity organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competitions (§2522(a)).

There is also a deduction for income tax purposes for charitable gifts, but that deduction is not unlimited; it is subject to a percent of AGI.

ANNUAL EXCLUSION GIFTS

PROGRAM OF GIFTS

For a married couple with a large estate, the use of the unlimited marital deduction and the Credit Shelter Trust may not be enough to eliminate estate taxes on the second estate. Consider a couple in their late 70s with a net worth of $3,800,000. Even if both husband and wife survive until 2006, this planning will enable them to transfer only $2 million free of estate tax to their children and grandchildren; $1,800,000 will be subject to estate tax, about $875,000.

This couple may want to proceed with a program of $10,000 annual exclusion gifts. If the couple has two children and three grandchildren, they may transfer $100,000 a year to their descendants (husband and wife together may transfer $20,000 a year to each descendant under the annual exclusion). If the couple proceeds with such a program of gifts for twelve years, the couple will transfer $1,200,000 (plus the income and appreciation on the donated assets) beyond the reach of the estate taxes. Given an applicable estate tax of approximately 48%, this would suggest an eventual estate tax saving of $576,000.

Several Observations

Several observations are pertinent:

1. A program of annual exclusion gifts can very effectively reduce the taxable estate of the parents and eventually to save significant estate tax.

2. Parents are well-advised to commence a program of annual exclusion gifts only if the program will not jeopardize the long-term financial independence and well-being of the parents.

3. Obviously it is not required that the full $10,000 a year be given. Many clients start a gift program on a go-slow pace, giving only to the children (and not to the grandchildren or in-laws). Similarly, many clients start with gifts of less than $10,000 a year.

4. Issues related to the timing of gifts, the equalization of gifts among the branches of the family tree, and property well-suited for gifts are discussed later in this chapter.

Gifts to Minors

Often a program of annual exclusion gifts is designed to transfer property to a minor. Because a minor, by definition, does not have the legal capacity to own property, the most common vessel for a gift to a minor is a custodial account or trust.

Most states create a custodial account under the Uniform Gifts to Minors Act (UGMA). In fact, many states have now generalized the custodial statute so that a custodial account can hold not only property received by gift but also property received by testamentary transfer (will). Many states now call this statute the Uniform Transfers to Minors Act (UTMA).

A UTMA account is a custodial account in which the custodian holds property on behalf of a minor. The UTMA statutes typically provide that the income and principal held in the custodial account may be used for "the benefit of" the minor. In most states the custodial account does not vest in the individual at the age of majority (age 18 in most states) but rather at age 21. The establishment of a UTMA account to hold annual exclusion gifts to a minor is a simple economical procedure. Virtually all banks, mutual fund companies, and financial institutions permit the establishment of a UTMA (or a UGMA) account.

From a federal gift tax perspective, the key is that a gift to a UTMA account qualifies as a "present interest" and therefore qualifies for the $10,000 annual exclusion.

Section 2503(c) Trust

As an alternative method to make a present interest gift, clients may establish a §2503(c) trust. It provides that a gift to a trust for an individual who is not yet 21 years of age shall nevertheless be considered a present interest gift and qualify for the $10,000 annual exclusion if the trust has the following attributes:

1. The property and the income therefrom may be expended by, or for the benefit of, the individual before attaining the age of 21 years.

2. To the extent the principal and income is not so expended, it will pass to the individual upon becoming 21 years of age (or in the event the individual dies before attaining 21 years of age, to be payable to estate).

CRUMMEY TRUST

Purpose

Though an UTMA account or a §2503(c) or §2503(b) trust is a simple and economical approach, there is the disadvantage that the child has the legal right to receive all of the property outright at age 21. This may not be the intent of the donor. Historically, then, practitioners searched for a method of transferring property to a trust for a child or grandchild which would have the following two attributes:

- Gift would constitute the transfer of a "present interest" and so would qualify for the $10,000 annual exclusion.

- Child would not have the right to withdraw/spend the property at age 21.

Limited Withdrawal Right

To meet this goal, planners now establish a trust which provides that the beneficiary (child/grandchild) has the right to withdraw the gift for a 30-day period after the gift is made to the trust. The child, or the parent acting on behalf of the minor child, has the legal right to make the withdrawal. The right is for a limited period; if the child does not exercise the right of withdrawal within 30 days, then the right lapses.

The right is generally non-cumulative; if the child decides to exercise the right of withdrawal in year two, the child can withdraw only the property given to the trust in year two (and not the property given to the trust in year one).

This technique — granting the beneficiary the right to withdraw the value of the gift for a limited period of time in order to qualify for the $10,000 annual exclusion — was first litigated in the case of *Crummey v. Commissioner*. The Crummey Court approved the technique.

Sample Provisions

By way of example, then, the grandparents may establish a trust for their 10-year-old grandchild with the following provisions:

- Independent trustee shall distribute income and principal for the health, support, maintenance, and education of the grandchild and the grandchild's future-born children.

- Each year the grandchild shall have a right for 30 days after the gift to the trust to withdraw from trust principal the lesser of:

    - Value of the gift.

    - $10,000 (or $20,000 if there is gift-splitting).

- The trust shall continue until the grandchild attains 35 years of age or dies. Upon termination at age 35, the remaining principal shall be distributed outright to the grandchild.

Vesting

Crummey Trusts can be a useful way to postpone the age of vesting of property transferred in trust to a child or grandchild by gift. As previously noted, an UTMA custodial account generally terminates when the child reaches 21 years of age. At that time the child has the absolute legal right to receive the property.

Similarly, a §2503(c) trust terminates when the child reaches 21 years of age. It is possible to provide that the child has a 30-day period beginning at age 21 to withdraw the property from a §2503(c) trust and that if no such withdrawal is made the property will continue in trust for an extended period.

However, a child at a troubled time in life, or dealing with problems of substance abuse, or under the influence of a scoundrel may choose to exercise the right of withdrawal. This legal fact — that the child has the legal right to withdraw the money from a UTMA custodial account or a §2503(c) trust at age 21 — must be considered in light of the appreciation of the property.

For example, if two grandparents establish a trust for a grandchild when the grandchild is three years old and contribute $20,000 a year, with 5% appreciation, the property will be worth well in excess of $550,000 when the grandchild becomes 21 years of age. The transfer of $550,000 outright to a child at age 21 may not be a constructive force promoting the child's hard work, education, and self-fulfillment. Therefore, using a Crummey Trust (with rights of withdrawal) may be an important planning vehicle.

To reiterate, the Crummey Trust can be structured so that the gifts constitute "present interest gifts" for purposes of the annual exclusion but the vesting of the property can be postponed until a child attains a designated age of maturity (or the vesting can be postponed until the child dies — the Crummey Trust may last for the entire lifetime of the donee-child).

TUITION — MEDICAL CARE

There is an annual exclusion for $10,000 as well as an exclusion for certain qualified transfers for education expenses or medical expenses. In addition to the $10,000 exclusion, there may be excluded from what would otherwise be a taxable gift:

1. Any amount paid on behalf of an individual as tuition to an educational organization for the education or training of such individual. The amount must be paid directly to the educational organization.

2. Any amount paid on behalf of an individual to any person who provides medical care with respect to such individual as payment for such medical care. The payment must be made directly to the medical provider.

Obviously, this provision can make possible substantial additional gifts.

Example 3-1:

- For Grandmother Smith, the apple of her eye is her only grandchild, Megan. Megan is a sophomore at an expensive private college.

- Each year Grandma Smith may exclude from what would otherwise be taxable gifts:

  - $10,000.
  - Full tuition paid directly to Molly's private college.
  - Cost of Molly's contact lenses.
  - Cost of Molly's doctor bills.
  - Cost of Molly's health insurance premium.
  - Cost of Molly's dental expenses.
  - Cost of Molly's other expenses for medical care (all paid directly to the medical provider).

Health Trust

Example 3-2:

- Grandfather George has one child and five grandchildren.
- Grandfather George establishes a bank account with his own money. However, Grandfather George authorizes his child, as agent, to write checks on the account for health purposes.
- The child pays all of the medical expenses for himself and his five children with checks (directly to the medical provider) written from the account.
- All of these distributions represent tax-free annual exclusion gifts (qualified transfers) (§2503(e)).
- In addition Grandfather George can give $10,000 each year to each of the six descendants.

Statutory Limitations

It is mainstream planning, then, to establish a trust as part of a family gift program. If a donor establishes a trust for a child or grandchild and makes gifts to that trust, several statutory limitations must be kept in mind.

Retained Interest

Section 2036 provides that the "value of the gross estate shall include the value of all property, to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, but has retained for his life or the possession or enjoyment of, or the right to the income from, the property."

Example 3-3:

- Donor makes a gift to his child, outright or in trust, with the legal provision that the donor will have the right to use the income or principal in the event of a health emergency.
- The value of the property would be included in the gross estate of the donor because the donor has retained the enjoyment of, or the right to the income from, the property.

Retained Control

Section 2036 also provides that the value of the gross estate shall include the value of any interest of which the decedent has made a transfer, but has retained "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or income therefrom."

Therefore, the general rule is that the transferor-donor should not serve as custodian of a UTMA account or any gift trust for a child or grandchild.

Example 3-4:

- Parent established a Crummey trust for his child with the provision that the parent shall serve as trustee until the child attains 35 years of age.
- If the parent dies, the value of the trust principal will be included in the gross estate of the parent — because the parent retained the right to govern the timing and/or allocation of distributions of income and principal.

PLANNING CONSIDERATIONS

Three-Year Rule

In the past, §2035 provided that if a person made a $10,000 annual exclusion gift and died within three years of the gift, the donated property would be "pulled back" into the gross estate of the donor. That is no longer the case. While there are certain exceptions (such as a transfer of a life insurance policy) the basic rule under §2035 is that an annual exclusion gift made during the three-year period ending on the date of the decedent's death is not part of the decedent's gross estate.

Therefore, if a donor with a substantial net worth makes a $10,000 annual exclusion gift on Monday and dies on Tuesday, the $10,000 amount is not part of the taxable estate. The resulting federal estate tax savings will be in the range of $3,700 to $5,500 (depending upon the applicable federal estate tax bracket).

Consider Grandpa Jones. He is 84 years old, has three children and six grandchildren. Grandpa Jones has a terminal illness, diagnosed just before Thanksgiving, and he has an apparent life expectancy of only two to six months. He is single.

One recommended planning strategy for Grandpa Jones would be to make $90,000 of annual exclusion gifts to the family members immediately and $90,000 in additional gifts on January 1 of

the next year. By making these gifts, Grandpa Jones would shift $180,000 out of his taxable estate. Even if Grandpa Jones died later in January, federal estate tax saving would result, possibly as high as $85,000 (depending on the applicable federal estate tax bracket).

Note that this strategy also applies with respect to "qualified transfers." Grandpa Jones may pay the tuition of any child or grandchild attending private school, perhaps prepaying the tuition at least through the end of the current academic year. Grandpa Jones may also pay any medical expenses directly to the provider; these gifts will not be part of Grandpa Jones' gross estate for federal estate tax purposes.

TIMING OF ANNUAL EXCLUSION GIFTS

Obviously, as noted above, it is advantageous to make $10,000 annual exclusion gifts early in the calendar year. If an individual postpones annual exclusion gifts until December and dies mid-year, the family has lost the associated federal estate tax saving.

EQUALIZING STRATEGY — LIFETIME GIFTS

Often, parents wish to proceed with two seemingly conflicting estate planning goals:

- To maximize use of the $10,000 annual exclusion.
- To treat equally the branches of the family tree.

Consider Grandmother Brown who has three children and six grandchildren. Assume that Grandmother Brown's oldest child has one child, that her middle child has two children, and that her youngest child has three children.

If Grandmother Brown proceeds with a program of $10,000 annual exclusion gifts to all descendants, she will annually give $20,000 to the "oldest branch" of the family tree, $30,000 to the middle branch, and $40,000 to the youngest branch. If she were to sustain such a program of gifts for ten years, the disparities would be very substantial:

Oldest Branch	$200,000
Middle Branch	$300,000
Youngest Branch	$400,000

To accomplish both goals, a family may consider combining $10,000 annual exclusion gifts and unified credit gifts. In this example, each year Grandmother Brown may proceed as follows. She may give $10,000 to her youngest child, $10,000 to each of those three grandchildren, all annual

exclusion gifts. She may give $20,000 to her middle child and $10,000 to each of those grandchildren; the $20,000 transfer to her middle child would be a $10,000 annual exclusion gift and a $10,000 "unified credit gift." She may give $30,000 to her oldest child and $10,000 to the associated grandchild. The gift to her oldest child would be composed of a $10,000 annual exclusion gift and a $20,000 "unified credit gift."

In total, Grandmother Brown annually would make $90,000 of the annual exclusion gifts and $30,000 of unified credit gifts. Each branch of the family tree would receive $40,000. This strategy — combining annual exclusion gifts and unified credit gifts — is a common method of maximizing the tax-saving benefit associated with the annual exclusion gifts and maintaining equality among the branches of the family tree.

EQUALIZING STRATEGY — CATCH-UP PROVISION IN WILL

There is an alternative strategy. If Grandmother Brown is not able to make lifetime gifts in this equalizing mode, Grandmother Brown may include an equalizing provision — a "catch-up" provision — in her will. That provision may be of the following sort:

> *During my lifetime I anticipate making annual exclusion gifts to my children, grandchildren, and in-laws. I shall keep a written record of such gifts or I may have my accountant keep a written record of such gifts. My personal representative (executor) may rely on such written records for the purposes of this Article. The personal representative shall compute the total value of lifetime gifts made after 1995 (other than holiday gifts and birthday gifts) to the family of each of my children. For this purpose the child's family shall include the child, the child's descendants, and the child's spouse. The personal representative shall compute the total amount of property given to each family. The highest total amount to a family shall be called the Target Amount. The personal representative shall make a distribution to any child whose family received an amount less than the Target Amount equal to the difference between the Target Amount and the amount of total gifts received by that child's family. If such child is not living, the distribution of that difference shall be to the child's descendants, by representation. The balance of my estate shall be distributed in equal shares to my children.*

This is obviously a simply drawn provision, but the idea is often used — the provision in the will to effect equalization among the branches of the family tree for a program of lifetime gifts. Notably there may be significant timing differences with respect to gifts to children during lifetime and a "catch-up provision" in the will. The child who receives property by lifetime gift may earn interest on such property and may gain the benefit of appreciation. Therefore, clients sometimes consider one of two alternative strategies:

Two Alternatives

1. Provide that the property given to a child during lifetime shall be valued at the parent's death — to provide the valuation for the catch-up gift. This is possible if the gift is of an interest in a family business or other property retained by the donee-child. It is more difficult if there may be sale by the child or commingling of the gift, resulting in a problem of "tracing" the gift.

2. Provide that there will be an imputed interest rate with respect to lifetime gifts, so that the child receiving the "catch-up gift" will receive not only the principal amount of the gift but also a designated interest rate from the date of gift until the date of the parent's death.

These two approaches to equalization should be given careful consideration. A program of annual exclusion gifts can be a very effective way to reduce the federal estate tax for a wealthy family. A program of equalization can help to maintain family harmony.

POWER OF ATTORNEY

As noted, if a person makes a $10,000 annual exclusion gift on Monday and dies on Tuesday, the $10,000 amount is not part of the decedent's taxable estate. Such a gift may be made by the individual or by an agent acting under a durable financial power of attorney.

Example 3-5:

- 80-year-old mother is living (the father has predeceased) and she appoints her daughter as agent under a durable financial power of attorney.
  - If the mother has a stroke or is otherwise incapacitated, the daughter may make gifts to family members under a durable power of attorney.

Two Provisions

From a practical standpoint, the power of attorney:

1. May provide guidelines or limitations with respect to the making of such gifts.

2. May, if the power of attorney so limits, permit gifts only of the $10,000 annual exclusion amount (plus direct payments of tuition and medical care).

From a legal perspective, the IRS has argued that gifts made by an agent under a durable financial power of attorney are effective for federal gift tax purposes only if the agent is expressly authorized to make gifts. The IRS has taken the position (and successfully in some cases) that it is not sufficient if the power of attorney is simply a broad general authorization.

Consider a power of attorney with the following authorization:

> *I authorize my agent to take any step or act of any kind, whatsoever, including any act which I could legally do in my own person.*The IRS takes the position that such a broad authorization is not adequate for purposes of the federal gift tax. Stated differently, a durable financial power of attorney must expressly authorize the agent to make gifts if such gifts are to be removed from the principal's (donor's) taxable estate. This is an issue which is often overlooked by estate planning attorneys.

Non-Tax Consideration

Timing

Understandably, parents (or a single individual) are reluctant to commence a program of systematic $10,000 annual exclusion gifts to children and grandchildren if the gifts may jeopardize their long-term financial independence and well-being. The decision whether to proceed with a program of $10,000 annual exclusion gifts, then, is often a function of the donor's age, financial situation, health, and level of risk aversion. For many planners, the general rule is to recommend a program of $10,000 annual exclusion gifts if the client is "very rich or very old." Regardless of how rich or how old, if the donor does not want to make a gift or embark on a gifting program, then the potential tax savings will not make it "right" and the donor should not make the gift.

Personal Impact

It is also important to consider the emotional-incentive-family effect on the recipient. Will a program of $10,000 annual exclusion gifts to a daughter hurt the masculine pride of the son-in-law? Will a program of $10,000 annual exclusion gifts reduce the incentive or work ethic of the child or grandchild? Will the child begin to expect the annual gifts; will the child look on the $10,000 annual exclusion gifts as an entitlement?

Parents may decide for personal reasons that the gifts should not be made on a predictable basis. Parents may also decide to include as part of the gifts certain transfers which make possible enjoyment for the family (and not pure financial transactions). One wealthy couple in their early sixties had two children (both married) and no grandchildren. Over five years, the parents went forward with the following gifts.

Year 1 $20,000 to each of the four individuals, including in-laws ($40,000 per family).

Year 2 All-expense-paid trip to Hawaii for all three families (including the parents). No other gifts.

Year 3 A pretty sweater to each of the four individuals over the holidays. No other gifts.

Year 4 $5,000 to each of the two children (but no transfer to an in-law). No other gifts.

Year 5 A new automobile for each of the two couples.

Though such a program of gifts does not maximize the benefit of the $10,000 annual exclusion, it is unpredictable (the children do not know what to expect) and it may have elements of family enjoyment.

LARGER GIFTS — APPLICABLE CREDIT AMOUNT

BASIC IDEA

For couples with very large estates, and particularly for those with appreciating assets, a program of $20,000 annual exclusion gifts may be only a start in reducing the eventual federal estate tax. The applicable unified credit ($650,000 in 1999 and increasing to $1 million in 2006) may be applied to transfers made during lifetime by gift or after death by will. For families with large estates, it may be useful to consider a large gift ($250,000 plus):

- To shift appreciating property to the second and third generations.
- To transfer property at a discounted value for federal gift tax purposes.

Example 3-6:

- A 70-year old couple owns an undeveloped tract of real estate with a value of $700,000. Assume the couple has other assets of $3,500,000.
- If the couple holds the real estate for 14 years and it appreciates at the rate of 9% a year, the real estate will have a value of $2,800,000 when the couple reaches 84 years of age.
- If the couple dies then, the transfer of the property will consume both full unified credits ($2 million) and still result in a taxable transfer of $800,000.
- By contrast, if the couple makes a gift of the $700,000 property, the transfer will use only a total of $700,000 of applicable credit protection.
- A current gift of the $700,000 tract of real estate will effectively shift $2,100,000 of future appreciation and result in an eventual federal estate tax saving of $1 million.

For couples with very large estates, then, making a large gift — to shift future appreciation beyond the reach of the federal estate tax — can be effective planning.

GENERATION-SKIPPING ASPECTS

As previously noted in Chapter 2, it is often advisable to combine two powerful planning ideas:

1. Making a large gift — to shift an appreciating asset out of the (eventually taxable) estate of the parent.
2. Transferring property to a generation-skipping trust for a child, so that the property will eventually pass free of estate tax and generation-skipping tax to the third generation.

Let's re-examine an example combining capitalizing on these two planning ideas.

Example 3-7:

- Couple with a large estate owns a farm on the outskirts of the city which is in the path of development.
- The real estate, which currently has a value of $800,000, may increase substantially in value in the future.
- The couple considers giving an undivided 50% interest ($400,000) to each of their two children — to shift the value and the future appreciation out of the parents' estates.
    - If the couple gives a $400,000 interest in the farm property to their 38-year-old daughter outright and the property is later developed into a shopping mall, the daughter's 50% undivided interest will be $3 million at her death.
    - The $3 million will presumably be included in the daughter's taxable estate, generating estate tax of approximately $1,500,000.

Establishing a Trust

The parents in the above example would be well-served to consider making the gifts (the $400,000 of farm property) to a generation-skipping trust for the child. For example, the parents may establish a trust for the daughter which provides as follows:

> *The trustee shall distribute income and principal to our daughter and the daughter's descendants as the trustee may deem necessary or advisable to provide for the health, support, maintenance and education of a beneficiary. The trust shall terminate upon the death of our daughter. Upon our daughter's death, she shall have a special power of appointment exercisable among our descendants. If our daughter does not exercise such special power of appointment, the trust estate remaining upon termination shall be distributed to her descendants, by representation. Our daughter shall be the sole trustee.*

The parents could establish a trust of this sort and could make the $400,000 gift to the trust taking two tax steps:

- Shielding the transfer from federal gift tax by application of the unified credit.

- Allocating $400,000 of the $1 million GST exemption (so that the trust would be "exempt" with an inclusion ratio of zero).

Significant Tax Savings

With this planning approach, the tax efficiency of the gift program would be greatly increased. Not only would there be significant tax savings on the transfer from generation one to generation two (from parents to daughter), there would also upon the eventual transfer from generation two to generation three (from the daughter to the daughter's children — the grandchildren).

For most sophisticated estate planners considering a program of large gifts for a client, the starting presumption is that the transfer to the child (or children) will be made in trust(s) exempt for generation-skipping transfer purposes. This can be very powerful planning. Some commentators assert that a large outright gift to a child is 50% good planning and 50% mistake. The outright gift of appreciating property to the child represents good planning between generation one and generation two but a mistake with respect to the eventual transfer of the appreciated property from generation two to generation three.

INCOME TAX CONSIDERATIONS

BASIS CONSIDERATIONS

With respect to property transferred by way of gift, the basis of the property in the hands of the donee is the same as the basis of the property in the hands of the donor. That is, the donee takes a "carryover basis."

By contrast, when a person dies the property which is part of the decedent's taxable estate for federal estate tax purposes receives a new basis equal to the net fair market value at the date of death. Accordingly, the recipients of testamentary transfers acquire property with a "step-up" in basis.

This distinction — that property received by gift has a carryover basis but property received by testamentary transfer has a stepped-up basis — is critically important in structuring a gift program. Particularly for an older donor with highly appreciated property, the planner must give careful attention to the basis consequences of gifts. The gifts of property to children and grandchildren may remove the donated property from the donor's taxable estate, and save estate tax, but the gifts lose the opportunity to obtain a step-up in basis which would occur if the property were transferred by will. For older donors, it is often preferable to make gifts of cash or high-basis property.

One planning technique is available for gifts of highly appreciated property in certain situations. Consider a Grandfather with an estate of $2,500,000, including highly appreciated stock. Assume that his wife is living but that she is in very poor health.

Grandfather may give $1,200,000 of highly appreciated stock to Grandmother. If she lives for 14 months and then dies, the stock will receive a step-up in basis in her estate. The inherent capital gain will be eliminated. This can be an effective strategy but it works *only* if the recipient (the wife in this example) *lives for at least one year* after receipt of the gift.

Section 1014(e) provides that "if appreciated property was acquired by the decedent [the wife in this example] by gift during the one-year period ending on the date of the decedent's death and such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent."

GIFT OR INHERITANCE — NOT INCOME

Though it is probably understood, note that neither a gift nor an inheritance is subject to income tax (except items constituting income in respect of a decedent such as funds in an IRA or qualified retirement plan passing to a non-spouse). The general rule of §102(a) is that "gross income does not include the value of property acquired by gift, bequest, devise, or inheritance."

CHAPTER 4

GIFT STRATEGIES — ADVANCED

INTRODUCTION

We have seen that a program of gifts may reduce eventual estate taxes. An individual may make $10,000 annual exclusion gifts to family members. An individual may make a larger gift to family members using the applicable unified credit.

In proceeding with such gift strategies, the **valuation** of the property for gift tax purposes is a key variable. The client-taxpayer has a strong interest in reducing — discounting — the value of the property for gift tax purposes. Several of the most popular (and effective) gift techniques hinge on discounting the value of the property for gift tax purposes. These techniques include:

- Family Discount Partnership
- Qualified Personal Residence Trust (QPRT)
- Grantor Retained Annuity Trust (GRAT)
- Charitable Lead Trust (discussed in Chapter 6)

FAMILY DISCOUNT PARTNERSHIP

HISTORICAL BACKGROUND

Historically a common estate planning strategy has been to hold investment assets or family wealth in a business entity. Before 1990, this was often a family limited partnership. Typically the parents were the general partners and the children (or trusts for the children) were the limited partners. There were several advantages to this strategy:

Control

The parents, as the general partners, retained control of all business decisions.

Liability Protection for Limited Partners

The children (or trusts for the children), as the limited partners, had no personal liability for claims against the partnership.

Ease of Conveyance

The making of gifts could be accomplished by a simple one-page assignment of a partnership interest. For a family limited partnership holding real property, it was not necessary to prepare and record deeds each year.

Discount

Because the limited partnership interest given to a child was generally a non-voting, minority interest, it was possible to **discount** the value for federal gift tax purposes. Generally these discounts were in the 15 to 20 percent range. A parent might transfer a 1.25% interest in a partnership holding $1 million of assets, taking the position that the discounted value of the 1.25% (minority) partnership interest for federal gift tax purposes was $10,000. Additionally, if there were restrictions placed on the transferability of the gifted interest, that would further discount the interest.

PLANNING DILEMMA

Before 1990, an individual had a dilemma in choosing the entity for a family holding company. A family limited partnership was (is) treated as a simple "pass through" entity for federal income tax purposes but subjected the general partner to personal liability. A corporation has the benefit of limited liability but creates corporate income taxes (even if the corporation is an S corporation).

In the last ten years, however, most states have created a number of new entities which combine the **limited liability** associated with corporate status with the **tax ease** associated with partnership treatment. These entities include:

- Limited Liability Company (LLC).
- Limited Liability Partnership (LLP).

In some states, there is a general partnership which nevertheless provides that there is limited liability protection even for the general partner. Generally such a partnership is "registered" and therefore is considered an RLLP.

- Limited partnership with the provision that there is limited liability protection for the general partner.

This is a limited liability limited partnership (LLLP) and is registered as an RLLLP.

- Limited Partnership Association (LPA).

A family limited partnership could also have as its general partner (the donors and usually the parents) an LLC — if in a state that allows LLCs.

FAMILY DISCOUNT PARTNERSHIP

In the 1990s planners have given consideration to the establishment of a "family discount partnership" (or LLC — the nature of the entity is not necessarily critical) as a vehicle to save gift and/or estate taxes. The family discount partnership is generally structured to **increase the amount of the discount** (and hence to reduce the value of the property interest transferred). The family discount partnership may be established to hold real property or to hold a portfolio of stocks and bonds.

For example, Grandfather Harrison holds a $2 million portfolio of publicly traded stocks and bonds. If he gives $30,000 of stock in a New York Stock Exchange company to a child or grandchild, the value will be $30,000 for gift tax purposes. If Grandfather Harrison dies owning the portfolio, these stocks and bonds will have a collective value of $2 million in his estate.

Grandfather Harrison may establish a family discount which could include the following provisions:

- Continuity

The partnership may not be dissolved for a period of ten years without the unanimous consent of the partners and it will not dissolve upon the death of a partner.

- Cash Flow Restriction

The partnership may distribute no more than two percent of the value of the partnership assets in any given calendar year.

- Restrictions on Investment

There should be no sale of any stock or bond owned by the partnership without the approval of at least two-thirds of the partners.

As an example, Grandfather Harrison established the Harrison Discount Partnership and gave away 10% of the interest in such partnership. If Grandfather Harrison died owning a 90% interest in the Harrison Discount Partnership which in turn held a $2 million portfolio, the IRS would typically argue that the partnership interest had a value of $1,800,000 in Grandfather Harrison's estate.

The Harrison Estate would argue, by contrast, that the 90% interest should be substantially discounted. The Harrison Estate might contend, for example, that the partnership interest would yield at any given calendar year only $36,000 (namely 2% of $1,800,000). A bond of medium investment grade yielding $36,000 a year might have a value of $600,000. Therefore the Harrison Estate might argue that the 90% partnership interest is more akin to a $600,000 bond.

The Harrison Estate could argue that the partnership interest is not even worth as much as a $600,000 bond. The owner of a $600,000 bond may sell the bond, convert it to cash, and spend it. The 90% partnership interest owned by Grandfather Harrison could not be transferred — the partnership was subject to limitations on dissolution and liquidation. Further, Grandfather Harrison did not have unilateral control of disposition which required at least a two-thirds majority.

These arguments, then, would suggest that there should be a substantial discount in the value of the partnership interest. Some professional appraisals might discount the value of the partnership interest by as much as 50% to 80%.

Possible IRS Attack of Family Limited Partnership

The IRS has considered several lines of attack with respect to the substantial discounts of the family limited partnership:

Sham Transaction

The IRS has asserted in several technical advice memoranda that the existence of the family partnership should be ignored for estate tax valuation purposes and that related partnership transactions should be regarded as a single testamentary transfer. (TAMs 9719006, 9723009, 9735003, and 9736004.)

Gift on Formation

In the above example, assume that Grandfather Harrison, with other family members, establishes the Harrison Discount Partnership on Monday and transfers assets to the partnership on Tuesday. The theory is that Grandfather Harrison had a portfolio worth $1,800,000 on Monday and a partnership interest worth $650,000 on Tuesday.

The IRS has contended that the **establishment** of the partnership and the associated transfer constituted a **gift** of $1,150,000 (namely the difference between $1,800,000 and $650,000). Presumably, the gift is to the other partners and potentially subject to federal gift tax. The IRS has not successfully sustained this attack in any court case but this approach is reflected in several private letter rulings.

Termination

Originally the IRS argued that a partnership would ordinarily dissolve on the death of the general partner (Grandfather Harrison) and therefore the restrictions (increasing the discount) were not effective at the death of the general partner. To blunt this argument, estate planners began drafting family limited partnerships with special provisions that continued the partnership (no dissolution) after the death of a general partner.

The IRS then took the position that the continuity of the family limited partnership would be honored for federal transfer tax purposes **only if** the continuation was dictated by state law. Most states responded by enacting and amending state statutes so that partnership and LLC entities would continue (without dissolution) even after the death of a general partner (or member in an LLC).

Typical Steps

In the formation of a family partnership (family discount partnership), the typical steps would be as follows:

1. Establish a family limited partnership (or LLC) with the necessary governing instruments, including a partnership agreement and a Certificate of Limited Partnership. The partnership agreement would contain restrictions on voting, cash flow distributions, and dissolution.

2. Name the senior generation members (and perhaps members of the second generation) as general partners (controlling members). Note that this planning has the virtue that senior generation — Grandfather Harrison in this example — may retain control.

3. The family limited partnership would hold real estate or possibly equity investments.

4. A professional appraiser would appraise the value of the partnership interest. Note that this appraisal would focus not only on the value of the underlying assets but also on the nature of the partnership interest (voting restriction, cash flow restrictions, etc.) and thus the basis for its discount.

5. The partnership agreement might provide that the family would have the right to reacquire the interest (by purchase) if any interest were ever owned by a non-family member (by reason of the divorce of one of the children).

6. There would be annual income tax returns required for the family limited partnership.

   Presumably the formation and the associated discounts would make possible tax effective transfers for gift and estate tax purposes.

CREDITOR PROTECTION

Although this is not the primary purpose, a family limited partnership or similar entity may provide aspects of asset protection. In some states, a family limited partnership may be a way to shield property from creditors.

POWERFUL TECHNIQUE

Family discount partnerships have become a popular technique used to reduce the value of assets for transfer tax purposes. For a program of annual exclusion gifts to children and grandchildren, the gifts of highly discounted interests in a family limited partnership can significantly increase the tax-free transfers to the second and third generation.

Three-Part Strategy

For larger gifts, there is often a three-part strategy:

1. Establish a family discount partnership to make possible a discount for gift tax purposes in the 30% to 80% range.

2. Transfer appreciating assets to the family discount partnership. Make a large unified credit gift ($500,000 plus) shifting future appreciation to the second and third generation.

3. Make the transfers of discounted interest in the family limited partnership to generation-skipping trusts so that the property interest would eventually pass to the third generation free of transfer taxes.

QUALIFIED PERSONAL RESIDENCE TRUST

BASIC TECHNIQUE

The Qualified Personal Residence Trust is a popular estate planning technique designed to make a gift of a personal residence at a discounted value for gift tax purposes.

Typically, a settlor creates a qualified personal residence trust (QPRT) and then transfers a personal residence to the QPRT. It can be either the settlor's principal residence or a vacation home. The settlor reserves the right to live in the home on a rent-free basis for a specified term. During that term, the settlor simply treats the personal residence as her own. At the end of the term, the trust terminates and ownership of the personal residence passes to the remainder beneficiaries, typically the children of the settlor. If the donor wants to continue living in the house (which she no longer owns) she should rent it at fair market value from its new owners (typically, the children).

This technique constitutes a gift to the children (as the remainder beneficiaries). However the value of the gift is not equal to the value of the residence at the time of transfer. There is a discount for gift tax purposes which reflects the fact that the children do not receive the residence upon the transfer of the residence to the QPRT. Rather the transfer of title to the children takes place at the end of the specified term.

Example 4-1:

- A settlor transferred a $550,000 residence to a QPRT, reserving the right to live in the residence for a term of 12 years. Upon termination of the trust, the residence will pass to the settlor's children.
- Given the 12-year wait, the gift to the children would not have a value of $550,000 but rather a value of $191,125.
- The value of the gift (and the associated discount) depends on the term of years. For a $550,000 residence and the respective term of years, the gift tax value would be as follows:

4 years	$398,750
8 years	$279,125
12 years	$191,125
16 years	$123,750

The QPRT may result in a very substantial tax saving. In the example above the settlor transferred a $550,000 residence to a QPRT with a 12-year term. During the intervening 12 years, the residence appreciated to $775,000 in value. The QPRT would thus enable the settlor to transfer a $775,000 asset to her children at a $191,125 gift tax value.

It is not necessary to pay out-of-pocket gift tax. The settlor may apply part of her $650,000 (1999) unified credit to avoid gift tax payment. (It is not possible to use the $10,000 annual year exclusion for these purposes because it is not a present interest transfer).

ATTRIBUTES

There is an important qualification: the tax saving does **not** result if the settlor does not survive for the term of years. In the example, if the settlor died 11 years after establishing the Qualified Personal Residence Trust, the residence would revert to the settlor and be part of her taxable estate. In that circumstance, the QPRT would be a "wash" for tax purposes; it would not confer a detriment or a benefit.

It is permissible to sell a personal residence owned by a QPRT. If the proceeds are invested in a new residence of equal or greater value, that new residence may be owned by the QPRT. If there are excess sales proceeds, those proceeds must be held in the QPRT providing an annual annuity payment to the settlor during the term of the trust.

INCOME TAX OFFSET

An income tax (capital gain) offset should be kept in mind.

Example 4-2:

- Settlor transferred a $550,000 residence to a QPRT with a basis of $275,000.
- During the intervening twelve years, the residence appreciated to $775,000 in value.
- When the children receive the property, they have a residence worth $775,000 with a basis of $275,000.
- If the children later sold the residence, there would be a taxable gain of $500,000 and a capital gains tax (federal and state) of approximately $125,000.

By contrast, if the settlor did not establish the QPRT but passed the $775,000 asset to her children as part of her estate, there would be a "step-up in basis." If the children sold the inherited residence with a stepped-up basis of $775,000, there would be no taxable gain and no income tax due.

This basis issue is not a problem if the residence is a family retreat or a vacation home which would not be sold by the children. However, if the plan is for the children to sell the residence, then the estate saving made possible by the QPRT is offset, in part, by the loss of the step-up in basis which would otherwise accrue at the settlor's death.

The estate tax saving is diminished by the corresponding income tax which the children must pay on the sale of the residence. In this example for a 12-year QPRT, the federal estate tax saving of approximately $290,000 is partially offset by the "lost" income-tax saving of $125,000.

SUMMARY - QPRT

The basic rules, then, are as follows:

1. The settlor establishes a Qualified Personal Residence Trust and transfers the personal residence into the trust.

2. The trust is irrevocable.

3. The settlor may be the trustee of the QPRT.

4. The residence may be a principal residence or a vacation home.

5. The property transferred to the QPRT must constitute just a personal residence — not adjacent acreage or ancillary out-buildings.

6. The settlor reserves the right to live in the residence for a specified term of years.

7. During the term of years, the settlor pays for improvements, taxes, insurance, and expenses, treating the personal residence as his/her own.

8. The QPRT provides that at the end of the term of years, ownership of the personal residence (or other trust corpus) will pass to named beneficiaries.

9. There is a gift to the ultimate beneficiaries, but the value of the gift is discounted for federal gift tax purposes to reflect the term of years.

10. If the residence is sold during the term of the trust, the proceeds must continue to be held in the trust. The proceeds may be reinvested in another residence or held as a pool of investment assets, providing an annual annuity to the settlor.

11. If the settlor dies before the end of the term of years, there is no tax saving (but no tax detriment either.)

12. If the settlor survives until the end of the term, the QPRT makes possible the transfer of a residence at a discounted value for gift tax purposes.

Recent Developments

The QPRT has been an area of important developments. The first was a series of amendments to the QPRT regulations which became final on December 22, 1997. Further, the Clinton administration has recently proposed legislation to repeal the QPRT provisions.

The new amendments affect certain income tax aspects of a QPRT. Previously, a common strategy was for the owner-settlor to **purchase** the residence back from the QPRT just prior to the end of the income term. The QPRT is a **grantor trust** and therefore no taxable gain would result, even if the donor purchased the property from the QPRT at a current market value larger than the cost basis of the property to the trust. The owner-settlor reacquired the residence in order eventually to include the residence in the owner's estate and to receive a step-up in basis for income tax purposes.

However, the amendments to the QPRT regulations **bar** such reacquisition of the residence. The regulations apply to a QPRT established after May 16, 1996, and require that the QPRT either prohibit a purchase of the residence by the donor or that the QPRT agreement be reformed to ensure such a prohibition.

GRANTOR RETAINED ANNUITY TRUST (GRAT)

Basic Technique

The Grantor Retained Annuity Trust (GRAT) and the Grantor Retained Unitrust (GRUT) are techniques for transferring property to members of the grantor's family at a discounted value.

Structure

The GRAT is very similar to the QPRT:

1. Grantor establishes an irrevocable trust.

2. The grantor may be the trustee during the term of years.

3. Grantor reserves the right to use the property for a term of years. In a GRAT, the grantor retains the right to a "qualified annuity interest" each year. This is a payment of a fixed annuity amount.

4. The trust lasts for a specified term of years which the grantor is expected to outlive.

5. At the end of the term of years, the trust estate passes to the remaindermen who are generally members of the grantor's family.

6. The grantor's transfer of property to the GRAT is treated as a gift to the remaindermen. The value of the gift is discounted equal to the present value of the remainder interest as determined under IRS evaluation tables.

Example 4-3:

- Henry is 65 years old.

- He creates a GRAT for a term of 10 years and funds the trust with property valued at $1 million.

- Henry retains the right to receive a 10% annuity; namely, $100,000 from the trust each year, the annuity amount payable in quarterly installments at the end of each quarter. The interest rate in effect is 8.6%.

- The present value of the remainder interest (i.e., the gift to the remaindermen) is $395,600.

A GRUT, by contrast, does not have an annual fixed annuity amount. Rather, the annuity amount is a percentage of the value of the trust estate at the beginning of the year. Valuing the remainder interest in a GRUT is more complicated than valuing a remainder interest in a GRAT.

TEMPORAL DIVISION

Historically estate planners have accomplished a substantial tax saving by dividing property on a "**time basis.**" Usually, the property is divided into:

- Right to use the property or the right to income for a specific term, sometimes measured by the life of one or more individuals, and

- Remainder interest.

When a transferor gives a temporal interest in property as discussed above and designates a remainder interest to someone else, the value of the gift is determined under IRC §7520.

The usefulness of these strategies was significantly reduced by the enactment in 1990 of §2702 which applies generally to all gifts of temporal interest in property. When §2702 applies, the transferor's gift is valued by subtracting the value of the transferor's retained interest from the value of the entire property and by assigning a **zero value** to the retained interest **unless** one of several exceptions applies.

Two Exceptions

The two most important exceptions are:

- Exception for certain residence trusts — the QPRT, and

- Exception for retained qualified interest.

It is the exception for retained qualified interest which permits the creation of a GRAT.

For further historical interest, it may be noted that previous law permitted a trust by which the grantor retained the right to income (but not necessarily a fixed annuity amount or a unitrust amount). This type of irrevocable trust, providing for a temporal division of property, was called a GRIT (Grantor Retained Income Trust). The enactment of §2702 effectively eliminated the GRIT, leaving the QPRT and the GRAT (or the GRUT) as primary planning techniques.

ADDITIONAL ADVANCED TECHNIQUES

DEFECTIVE GRANTOR TRUST

For clients making a large gift in trust for a child (or grandchild), the usual strategy is to structure the trust as an irrevocable trust with the following characteristics:

1. The assets in the trust are removed from the estate of the parent-transferor. The parent-transferor is not considered the "owner" for estate tax purposes.

2. The income of the irrevocable trust is not considered income of the parent-transferor. The parent-transferor is not considered the "owner" for income tax purposes.

Example 4-4:

- Father established an irrevocable trust for his son and transferred a rental property with a value of $550,000 which yielded annual net rental income of $35,000.

- The trust provided mandatory distribution of income to the son and the distribution of principal to the son and the son's descendants for health, support, maintenance and education.

- Upon the son's death, the remaining trust principal will pass to the son's descendants, by representation. The son is the sole trustee.

- In the usual mode, the $35,000 of annual income would be part of the gross income of the son, reported on the son's Form 1040. The son would owe the associated income tax of approximately $8,000 to $14,000.

Restructuring Trust

The planner may consider, however, structuring the irrevocable trust so that the parent-transferor (and not the son) is considered the "owner" of the income for federal income tax purposes. Section 675 provides, for example, that the grantor (parent-transferor) shall be treated as the owner of any portion of a trust in respect of which:

> A power exercisable by the grantor (parent-transferor) enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security.

Similarly, another power under §675 is the power to reacquire the trust property by substituting other property of equivalent value which is exercisable in a non-fidicuiary capacity without the approval or consent of any trustee. If the Grantor retains such a power, then the grantor is treated as the owner for income tax purposes.

In essence, an irrevocable gift trust may be structured so that the parent-transferor is considered the "owner" (grantor) for federal income tax purposes. This can be accomplished by attributing one of the administrative powers under §675 to the grantor (parent-transferor).

Effectively, this enables the transferor to make an **additional gift** each year without using any of the annual exclusion or unified credit protection. The transferor is paying what otherwise would be a legal obligation of the son. This payment of the income tax, however, is not treated as a gift for gift tax purposes. Depending on the son's income tax bracket, the father in this example is making a tax-free gift to the son each year of approximately $8,000 to $14,000 without penalty.

This technique — structuring the trust so that the transferor remains the "owner" for income tax purposes and therefore is obligated to pay the associated income tax — may be used with a number of the trust techniques discussed elsewhere in this book including, for example, the irrevocable life insurance trust.

CRISTOFANI TRUST

On occasion a grandparent (or grandparents) seeks to accomplish two goals:

1. Maximize the annual exclusion gifts to children, grandchildren, and family members.

2. Preserve the funds for use by the child (and not the grandchild or in-law).

This may be accomplished with a trust of the following sort: Grandparents establish an irrevocable trust which provides that their daughter, her four children, and their son-in-law each have a Crummey right of withdrawal — a 30-day period in which to withdraw the amount of the gift allocable to the family member or $20,000, whichever is less. The trust names the daughter as the sole trustee.

The trustee may distribute income and principal to the daughter, her children, and her husband for health, support, maintenance, and education. Upon termination at the daughter's death, the remaining trust estate passes to the daughter's descendants, by representation.

A trust of this sort is often called a Cristofani Trust, following the case of *Cristofani vs. Commissioner*, 97 T.C. 74 (1991). In the above trust the trustee (the daughter) has the authority to make all of the income and principal distributions to herself. There is no requirement to distribute income or principal to a grandchild or to an in-law.

This structure enables the grandparents to "use" the $20,000 annual exclusions which attach to the grandchildren and son-in-law without actually transferring property to them. Although the Cristofani court approved this technique in 1991, the IRS continues to oppose this planning approach. The taxpayer's prospect of succeeding in this arena is improved if one or more of the following conditions is met.

Conditions for Success

- Grandchild (and son-in-law) not only has a Crummey withdrawal right but also is a permissible distributee of income or principal.
- Grandchildren (or at least a grandchild) exercise part or all of the Crummey withdrawal right from time to time.
- Occasional distributions of income or principal to the grandchildren and to the son-in-law occur from time to time.
- Each grandchild is a vested remainderman. That is, each grandchild will certainly inherit part of the trust estate remaining upon the death of the child. Stated differently, the child does not have a special power of appointment, with the associated authority to "disinherit" the grandchild.

Some clients have included in-laws (the son-in-law or the spouse of a grandchild in the above trust) as persons with a Crummey withdrawal right. This is done to expand the power of the $10,000 annual exclusion. The IRS will likely question this structure if the in-law is not a permissible distributee of income or principal or otherwise is only a "theoretical beneficiary."

Elements of the Case

In the *Cristofani* case, the grantor, Maria Cristofani, established a trust for the benefit of her two children. She made Crummey gifts to the trust on behalf of her children and her five grandchildren (gifts of fractional shares of real property). The trust provided that if either of the grantor's children pre-deceased her, that child's share of the trust would pass to the grantor's grandchildren. The IRS maintained the five grandchildren were merely "contingent"beneficiaries — that they might never see benefit from the trust.

The IRS pointed out that none of the grandchildren ever exercised any of their withdrawal rights, suggesting that the grantor's real intent was to benefit her two children. The suggestion is that the grantor and the beneficiaries had a "pre-arranged understanding."

The *Cristofani* technique has worked, but the argument against the IRS will be particularly strong if a grandchild and/or in-law does from time to time exercise a withdrawal right and if there are at least modest occasional distributions to these family members.

TAXABLE GIFTS

BASIC TECHNIQUE

Although **unified system** of federal gift taxation and federal estate taxation exist, there is a fundamental difference between the gift tax and the estate tax. There is gift tax paid on the value of the gift; there is no gift tax paid on the funds used to pay the gift tax. There is estate tax on the value of the property included in the gross estate including the funds used to pay the estate tax. Stated differently, the funds used to pay the gift tax are not themselves subject to gift tax. The funds used to pay the estate tax are themselves subject to estate tax.

Example 4-5:

- Grandfather Abrams has used all of his applicable unified credit on prior gifts. He is considering a $1 million transfer to his children Ernie and Barbara. He is trying to decide whether to make the transfer by lifetime gift or by testamentary bequest.

- If Grandfather Abrams makes a gift of $1 million to his children ($500,000 each to Ernie and Barbara), associated gift tax of approximately $500,000 will occur.

- Of the total of $1,500,000, the disposition of funds will be as follows:

Ernie	$500,000
Barbara	$500,000
IRS	$500,000

- By contrast, if Grandfather Abrams keeps the $1,500,000 and transfers it to his children in equal shares under his will, a larger tax and a smaller net inheritance to each child will occur.

- The $1,500,000 in Grandfather Abrams' estate will attract estate tax of approximately $750,000. The net disposition of property will be approximately as follows:

Ernie	$375,000
Barbara	$375,000
IRS	$750,000

For clients with large estates, then, it may be sensible to consider **taxable gifts** as a technique to reduce total transfer taxes.

QUALIFICATIONS - CONSIDERATIONS

The technique of reducing the total federal transfer tax by making taxable gifts must be subject to several considerations.

Three-Year Rule

If a donor makes a taxable gift and dies within three years of the gift, the amount of the gift tax is "pulled back" into the donor-decedent's estate and is subject to estate tax (§2035(b)).

Step-Up in Basis

When there is a taxable gift of cash, there is no consideration with respect to basis. However if the donor is making a gift of appreciated property, then there must be consideration of the carryover basis (gift) **versus** a step-up in basis (testamentary transfer).

In the above trust, if Grandfather Abrams makes a $1 million gift of highly appreciated property to Ernie and Barbara and survives the gift by three years, there may be a savings of total transfer taxes but Ernie and Barbara will have a carryover (low) basis in the property. By making a taxable gift, the Abrams Family will lose the step-up in basis which would occur if the appreciated property were included in the gross estate of Grandfather Abrams.

Time Value of Money

One obvious effect of making a taxable gift is to **accelerate** the payment of the transfer tax. By making the taxable gift, the Abrams Family pays $500,000 of tax **earlier** than would otherwise be necessary. Therefore, in preparing the financial projections about the advisability of the taxable gift, the planner must also consider:

- Time value of money.
- Income which would be earned on the $500,000 during Grandfather Abrams's period of survivorship. It is of course pertinent that the income may be subject to income tax and that the net accumulated income would be subject to estate tax in Grandfather Abrams's estate.

- Investment opportunity (and possible appreciation) lost by reasons of the $500,000 "early" payment of federal transfer tax. If Grandfather Abrams made no taxable gift but instead used the $500,000 to purchase stock in a start-up company, there is the possibility that the investment appreciation during Grandfather Abrams's life would more than offset the tax savings. Again, it is understood that such appreciation would be subject to estate tax in the gross estate of Grandfather Abrams.

CREDITOR PROTECTION TRUST

Though not established to save gift tax or estate tax, it should be mentioned that planning often occurs to shield property from creditors. Historically, one possible technique for a person facing severe creditor risk would be to transfer property to an offshore trust. The laws in a number of offshore jurisdictions (including the Isle of Man in the North Sea) are generally pro-debtor and anti-creditor.

ALASKA TRUST

Recently, two states — Alaska and Delaware — have enacted laws which provide special protection from creditors. The Alaska trust (the tundra trust) has received the most attention. Under the Alaska Trust Act, a person may establish an irrevocable trust to protect assets from creditors and to give the settlor of the trust access to trust distributions at the discretion of a third-party trustee. The Alaska trust provides creditor protection superior to the protection afforded in most other U.S. jurisdictions.

Key Characteristics

An Alaska trust has the following key characteristics:

1. The trust must have a resident of Alaska or a domestic Alaskan bank as the trustee.

2. The trust must be irrevocable.

3. The trust permits distribution of income and principal to the settlor but does not mandate distribution of income and principal to the settlor.

4. The assets in trust are generally beyond the reach of the settlor's creditors (assuming the establishment of the trust and the conveyance of the assets does not constitute a"fraudulent transfer" — a transfer made with the actual intent to hinder, delay or defraud creditors).

5. The trustee must maintain the records and prepare the trust tax return.

6. Some of the trust assets must be held in Alaska and at least a portion of the trust administration must be performed in Alaska.

Earlier chapters showed that a trust may be an effective vehicle to shield property from creditors. In those contexts, however, if Transferor A (Jefferson) established a trust for Beneficiary B (daughter), the property held in trust may be protected from the creditors of Beneficiary B (daughter). An Alaska Trust offers a technique by which a **settlor** may establish a trust and protect the assets from the **settlor's** creditors. The strength of an Alaska trust (or a similar trust in Delaware) has not yet been confirmed by court cases but it is a technique to keep in mind for clients who may have significant creditor exposure. A limited partnership interest in a family limited partnership (FLP) may also serve as a barrier to future creditors and protect the assets. The limited interest can be attached by a creditor with a judgment against the limited partner, but the creditor cannot foreclose upon and take title to the limited partnership interest. The creditor becomes an assignee of, but not the owner of, the interest, and the creditor may be required to pay income tax on his or her share without necessarily being entitled to cash distributions from the partnership. Sometimes, this feature can encourage a favorable settlement.

CHAPTER 5

INSURANCE PLANNING

BASIC RULES

SECTION 2042

The value of the gross estate shall include the value of the amount receivable by all other beneficiaries (other than the executor) as insurance under policies on the life of the decedent in which the decedent possessed at his death any of the incidents of ownership, either alone or in conjunction with any other person (IRC §2042).

Example 5-1

- Frank and Nina, a married couple, have an estate of $2,600,000. Even with traditional Credit Shelter Trust planning, at least $600,000 will be subject to estate tax in the second estate.
- Frank decides to purchase a $1 million term life insurance policy on his life, in part to provide funds for the payment of estate tax on the second estate. Frank owns the policy and names Nina as the beneficiary.
- If Frank dies, the $1 million of proceeds will pass to Nina free of estate tax (unlimited marital deduction).
- If Nina later dies, the $1 million of proceeds (and the associated investment assets and appreciation) will be subject to estate tax in Nina's estate, resulting in estate tax in the $450,000+ range.

Income Tax Rule

Gross income "does not include amounts received (whether in a single sum or otherwise) under a life insurance contract if such amounts are paid by reason of the death of the insured" (§101). However, gross income sets forth an exception in the case of a transfer for valuable consideration. If life insurance is sold or otherwise transferred for value, then the amount of the life insurance proceeds excluded from gross income may not be greater than the sum of the consideration plus the premium and other amounts subsequently paid by the transferee.

This result — that the proceeds may be included in gross income if there was a transfer of the policy for valuable consideration — does not apply if the transfer is:

- To the insured,
- To a partner of the insured,
- To a partnership in which the insured is a partner, or
- To a corporation in which the insured is a shareholder or officer.

OWNERSHIP ALTERNATIVES

Spouse as Owner

Pre-1981

Before 1981, no unlimited marital deduction for estate tax purposes existed. Following the example above, if Frank purchased a $1 million life insurance policy in 1979 naming Nina as the beneficiary and then died in 1980, the entire $1 million of proceeds could not be excluded from estate tax. To reiterate, at that time there was no unlimited marital deduction. If Frank died and the proceeds passed to Nina, one-half of the proceeds would be included in Frank's estate (the first estate).

Accordingly a sensible planning technique before 1981 was for the non-insured spouse to own the policy. If Nina owned the $1 million policy on Frank's life (naming herself as beneficiary) and if Frank died, the proceeds were payable to Nina but the $1 million was not included in Frank's gross estate for estate tax purposes. Under §2042, Frank had no "incident of ownership" in the $1 million policy.

Non-U.S. Citizen

This type of plan is still relevant if the surviving spouse is not a U. S. citizen. If the husband purchases a $1 million life insurance policy payable to his wife and dies in 1999, and his wife is not a U.S. citizen, there will be estate tax on the proceeds payable to the non-U.S. citizen spouse (unless a retroactive QDOT is established). Ownership of a life insurance policy on a spouse's life by non-U.S. citizen continues to be good planning in this context.

Planning – 1981 to Present

Otherwise, that type of planning with wife Nina owning the policy on husband Frank's life is no longer necessary to avoid estate tax on the first estate. Given the unlimited marital deduction, if Frank dies first owning the policy payable to Nina, all $1 million will pass free of estate tax to Nina.

The $1 million of proceeds will pass to Nina free of estate tax regardless of who owns the policy. Upon Nina's death the $1 million of proceeds (and investment appreciation) will be subject to estate tax in her estate.

If Nina owns the policy on Frank's life and if she dies **first**, the ownership of his policy will be transferred to the Credit Shelter Trust under Nina's will. The more conservative position is that Frank not be the trustee with respect to the policy. When Frank dies, all assets in the Credit Shelter Trust (including the $1 million of insurance proceeds) will pass free of estate tax to the second generation.

Structuring the ownership so that wife Nina owns the policy on Frank's life, represents "iffy" estate planning. It will result in an estate tax saving only if

- Nina dies first, and
- Ownership of Frank's policy passes, at her death, to someone other than Frank.

Ownership by Children

Another planning alternative is for a life insurance policy on the father's life to be owned by the children.

Example 5-2:

- Frank and Nina have two children, Rex and Lindy.
- If Rex and Lindy purchase and own the $1 million life insurance policy on Frank's life (with the proceeds payable to the children), then there will be no estate tax on the proceeds at Frank's death.
- Further there will be no estate tax on the investment proceeds at Nina's later death.

This planning can sometimes accomplish tax-saving and meet desired family goals, but the children's ownership of the life insurance policy has several qualifications.

Young Children

This strategy may not work well if the children are young. Assume Rex and Lindy are 18 and 20, respectively. Is it good estate planning for $500,000 to pass outright (at Frank's death) to each child at that age?

Needs of Surviving Spouse

In the above example if Rex and Lindy own the policy, the proceeds pass to them, **not** Nina. One of the reasons for life insurance coverage is to make funds available to the surviving spouse. If the policy is owned by the children, the proceeds are not available for the surviving spouse. If Rex and Lindy own the policy and name Nina as the beneficiary, there is a $1 million (potentially taxable) gift by Rex and Lindy to Nina on the death of Frank.

No Generation-Skipping

If Rex and Lindy own the policy outright, it is not possible to structure the ownership arrangement in generation-skipping trusts (so that proceeds would eventually escape estate taxation in the respective estates of Rex and Lindy).

OWNERSHIP BY PARTNERSHIP

It may be advantageous if a partnership owns Frank's life insurance policy. This partnership may be a limited partnership in which Nina is a 2% general partner and Rex and Lindy are each 48% limited partners.

This planning has two advantages:

- **Control**

  Nina, as the general partner, can control the investment and expenditure of the proceeds.

- **Tax-Saving**

  Only 2% of the value of the partnership assets will be included in Nina's taxable estate upon Nina's later death.

This planning has the continuing detriment that only 2% of the funds are available to Nina for her health, support, and well-being.

Ownership of life insurance by a partnership may be more sensible if the children are older and if the family is seeking a mechanism for the simplified ownership of a large policy. It may be particularly suitable when the insurance policy is purchased to provide liquidity for the payment of federal estate tax on the second estate rather than to provide funds for the surviving spouse.

IRREVOCABLE LIFE INSURANCE TRUST (ILIT)

PLANNING TECHNIQUE

The mainstream planning device to avoid taxation of life insurance proceeds is to have the policy owned by an irrevocable life insurance trust (ILIT).

Example 5-3:

- Frank establishes an ILIT. The ILIT provides that if Frank dies and Nina survives, the proceeds will be held (and invested) in the ILIT.
- The income and principal of the ILIT will be available for the health, support, maintenance, and education of Nina, Rex, and Lindy.
- Nina will be the sole trustee and she will also have a testamentary special power of appointment over the ILIT exercisable among Frank's descendants.

Note: This will not work the same way in a community property state.

If Frank dies, the ILIT works much like a traditional Credit Shelter Trust and may be structured identically to a Credit Shelter Trust. The funds are wholly available for the health, support, maintenance, and education of the family but are not included in Nina's estate for estate tax purposes.

Even with the increase in the unified credit amount, the maximum that can be transferred to a Credit Shelter Trust in 2006 is $1 million. For an ILIT, the maximum that can be held in the trust, protected from estate tax in the survivor's estate, can be much more. If Frank's ILIT were to purchase a $20 million term life insurance policy, all $20 million would pass free of federal estate tax to Nina and then later free of estate tax to Rex and Lindy. The associated estate tax saving resulting from an ILIT can be very substantial.

TRUSTEE

The insured person may not be the trustee of the ILIT. If Frank established an ILIT and named himself as trustee, the proceeds would be included in his gross estate (§2036 — because Frank had retained a right of control).

There is no **"spousal unity"** for purposes of §2036. Frank can establish an ILIT and name Nina as the original trustee. Nina will be the trustee during Frank's life. Assuming Nina survives Frank, Nina can continue to be the trustee without causing inclusion of the trust assets in her estate. This follows the substantially identical rules which govern a Credit Shelter Trust: Nina may be the sole trustee of the Credit Shelter Trust established under Frank's will, with the income and principal available for her health, support, and maintenance, without causing inclusion of the trust assets in her estate at her later death.

THREE-YEAR RULE

Chapter 3 discussed the general rule with respect to a transfer of property of less than $10,000 within three years of an individual's death. If Frank made a cash gift of $7,500 to Rex and Lindy and died one week later, the $7,500 would not be included in Frank's gross estate (assuming he had made no other gifts to the children in that calendar year).

However, the gift of an interest in a life insurance policy is an exception to the general rule under §2035. If Frank purchased a $1 million term life insurance policy, gave that policy to another person (Rex and Lindy, or an ILIT) and died within three years of the transfer, the face amount of the policy ($1 million) would be included in his gross estate.

If Frank decides to establish an irrevocable life insurance trust, it is preferable if the ILIT (the trust itself) purchases the life insurance policy on Frank's life. Then the three-year rule does not apply. If the ILIT is the original purchaser of the $1 million policy, Frank has made no transfer of the policy and therefore does not face estate inclusion under §2035.

FUNDING — WITHDRAWAL RIGHTS

Example 5-4:

- Frank establishes an ILIT naming Nina as the trustee, and the ILIT purchases a $1 million term policy on Frank's life.
- To provide funds for the payment of premiums, Frank may make annual gifts to the ILIT. These gifts, however, do not necessarily qualify for the $10,000 annual exclusion which attaches to present interest gifts.

In order for the annual cash gifts to the ILIT to qualify as **"present interest"** gifts, and thus qualify for the $10,000 annual exclusion, an ILIT customarily grants to descendants the right to withdraw the transferred amount within 30 days of the gift. These are the traditional Crummey withdrawal rights discussed in Chapter 3. The ILIT may provide:

> *In each calendar year in which I transfer property to the trust, each of my descendants who is living on the date of such transfer may withdraw from the principal of such trust the lesser of: (a) the full amount of such transfer divided by the number of my descendants living on the date of such transfer; (b) $20,000 if my spouse and I notify the trustee at the time of such transfer that we intend to consent under §2513 of the Code and treat such transfer as having been made one-half by each of us; or (c) $10,000 if my spouse and I do*

not so notify the trustee. Each such right of withdrawal shall be noncumulative and must be exercised within 30 days following the transfer which gives rise to such right by a written notice to the trustee, provided in all events such right must be exercised by the last day on the calendar year in which a transfer is made.

PAYMENT OF PREMIUMS

Use of Applicable Credit Amount

For large policies and/or older insured clients, the premiums may exceed the annual exclusion, even after gift-splitting is applied. The unified credit can then be used for gifts of the premiums. The payment of premiums is a good use of the unified credit because it enables the later transfer of a much larger amount — the insurance proceeds. Effectively there is "leverage" of the unified credit.

TRUST AS OWNER AND FIRST BENEFICIARY

After the transfer of the policy to the ILIT, the ILIT must be the owner of the policy. The ILIT must also be the beneficiary of the policy (and accordingly receive all of the proceeds upon the death of the insured).

PURCHASE OF ASSETS FROM THE ESTATE

Using life insurance for estate planning purposes provides liquidity to an estate for the payment of taxes and other expenses. The terms of the ILIT will typically provide that the trustee of the ILIT may purchase assets from the estate of the insured at fair market value, thus providing the estate with cash needed for the payment of taxes. The ILIT continues after this transaction, now holding assets purchased from the estate.

Note the purchase of the assets from the estate generally does not trigger taxable gain to the estate (on the sale of the assets to the ILIT) because the assets have received a step-up in basis at the insured's death. Ordinarily the ILIT does not end with the death of the insured. Typically, it continues either as a trust for the surviving spouse or is divided into separate trusts for the children.

ILIT SURVIVORSHIP POLICY

PURPOSE

Due to the unlimited marital deduction, generally no federal estate tax is due on the first estate. Rather, the second estate may trigger a substantial estate tax bill. To meet this cash need, a couple may purchase a **second-to-die** life insurance policy. The proceeds of such a policy are payable upon the death of the survivor of the two insured persons. Because it is a policy on two lives, a second-to-die life insurance policy is substantially less expensive than a policy on one life.

The same estate tax considerations attach to the ownership of the policy. If the survivor has an incident of ownership in the policy, then the policy proceeds will be subject to estate tax in the survivor's estate. If the children own the policy, the proceeds will not be subject to estate tax. If an ILIT owns the policy, the proceeds will not be subject to estate tax.

STRUCTURE OF THE TRUST

Trustee

For an ILIT holding a second-to-die policy, neither of the insured parties may be a trustee. If the surviving spouse is a trustee, then the proceeds will be subject to estate tax in the surviving spouse's gross estate.

Standard Provisions

An ILIT owning a survivorship policy is subject to the same rules discussed above:

- Three-year rule.
- Present interest requirement (often associated with Crummey withdrawal rights).
- Owner-beneficiary. The ILIT should be the owner and the first beneficiary of the second-to-die policy.
- Purchase of assets. It is contemplated that the ILIT will purchase assets from the estate of the survivor, making cash funds available for the payment of estate tax and extending the term of the ILIT.

GENERATION-SKIPPING PLANNING

As noted, life insurance can be described as an appreciating asset. The tax planning associated with an irrevocable life insurance trust can be quite powerful.

Example 5-5:

- Frank established an ILIT which purchased a $1 million policy on his life. The annual premium was $7,500.
- If the ILIT was structured with traditional Crummey withdrawal rights, and if Frank died shortly after the policy was purchased, the family would have effectively positioned $1 million for eventual transfer to the second generation free of federal estate tax.
- This "positioning" would have been accomplished using only $7,500 of annual exclusion protection.

Given the "appreciating" nature of life insurance, it is often advisable to structure an ILIT as a generation-skipping trust. The ILIT would provide:

> *Upon my death if my wife survives me, the trustee shall hold the trust estate for my spouse and my descendants. The trustee shall distribute income and principal to any one or more of my spouse and my descendants as the trustee determines to be necessary or advisable to provide for health, support, maintenance, and education. Upon the death of my spouse, the trust estate shall be divided into shares for my descendants then living, by representation. Each share shall be held in trust for the descendant. The descendant shall be the sole trustee of the trust. The trustee shall distribute income and principal to such descendant and his/her descendants as the trustee may determine to be necessary or advisable to provide for health, support, maintenance, and education.*
>
> *This trust for my descendant shall terminate upon the death of the descendant. Upon termination such descendant shall have a testamentary special power of appointment exercisable among my descendants. If such descendant does not exercise such testamentary special power of appointment, the remaining trust estate shall be distributed to such descendant's then living descendants, by representation.*

BENEFIT

There may be substantial benefit from structuring the ILIT as a **generation-skipping trust**. Not only will the proceeds and associated investment assets eventually pass free of estate tax to the **second generation**, it will also be the case that the investment assets will eventually pass free of estate tax to the **third generation**.

In effect, this is a variation of an observation made in Chapters 2 and 4. For a gift of an appreciating asset, it is wise to design the gift using a generation-skipping trust.

The recommendation that an ILIT be structured as a generation-skipping trust has a critical effect on the withdrawal rights. It is generally not possible to structure an ILIT as a generation-skipping trust if a descendant has a Crummey withdrawal right greater than $5,000. Therefore, in establishing an ILIT as a generation-skipping trust, the planner generally must consider one of two alternatives.

TWO ALTERNATIVES

Limited Withdrawal Rights

The annual withdrawal right must be limited to $5,000 or 5% of the value of the trust estate.

Note: If this structure is adopted, a gift tax return must be filed each year, with an associated Notice of Allocation, allocating part of the insured-transferor $1 million generation-skipping tax exemption. This is true even though there may be no gift tax due by reason of the $10,000 annual exclusion. If no gift tax return is filed, the ILIT loses its character as a generation-skipping trust.

No Withdrawal Rights

Alternatively, and this is relatively common planning, the ILIT may be structured with **no** Crummey withdrawal rights. The annual gifts to the ILIT (to pay the premiums) will be shielded from gift tax by application of the unified credit. It will be necessary to file a gift tax return applying the necessary amount of unified credit and allocating part of the insured-transferror's $1 million GST exemption.

PLANNING CONCEPTS

EQUALIZATION USE

The purchase of life insurance and its ownership by an ILIT may be useful for a family with a significant family business managed by one child.

Example 5-6:

- Todd and Alicia have an estate worth $4 million, including a contracting business with a value of approximately $2,800,000. Todd and Alicia have three children.
- Their daughter Amanda runs the contracting business and is very skilled in this position.
- Daughters Wendy and Robin live out of state; both are homemakers.
- Todd and Alicia have wills which include traditional Credit Shelter Trust planning.
- If Todd dies in 1999 and Alicia dies in 2000, it may be possible to shield $1,950,000 of value from federal estate tax (using both unified credits and the available portion of the $1,300,000 small business exclusion).
- This will leave a taxable estate of approximately $2,050,000 and corresponding estate tax of approximately $960,000.
- If the family home, investments, and non-business assets are sold to pay the estate tax, then the assets remaining for distribution may be as follows:

Family Business	$2,800,000
Cash	$ 240,000

- If the estate is distributed in one-third shares to the three children, there are at least two common alternatives:
  - Voting interest in the company passes to Amanda. She pays herself a substantial (and reasonable) salary. She has "guaranteed" continuing employment. The business pays no dividend. Wendy and Robin each own one-third of the business but each has a "non-spendable inheritance," creating a possible family conflict.

Alternatively, voting control passes to Wendy and Robin. They decide to sell the business or impose controls on Amanda's management, creating another possible family conflict.

When a family business comprises a significant part of a family's estate and one child runs the business, it may be advisable to purchase life insurance. Todd and Alicia could establish an ILIT. The ILIT could buy a $2 million survivorship life insurance policy providing that the funds be payable in equal shares to the three children (and perhaps Wendy and Robin could have a "put" to sell stock in the company to Amanda for at least the value of the life insurance proceeds received by Amanda). This sort of planning could protect the family business for Amanda and provide a (tax-free) "spendable inheritance" to Wendy and Robin.

CHILDREN BY PRIOR MARRIAGE

Life insurance, combined with an ILIT, can also be an effective "equalization tool" for a person with a large estate and children from a first marriage.

Example 5-7:

- Ben is 58 years old, has an estate worth $3,400,000, has two children from a prior marriage, and is married to 44-year-old Wanda.
- Ben prepares a will with the following plan:

  If my wife and any descendant of mine survives me, the personal representative shall set aside an amount equal to the applicable credit amount. This amount shall be distributed to my children in equal shares. The balance of my estate shall be distributed in a QTIP trust for my wife.

- If Ben dies in 1999 with an estate of $3,400,000, the funds available to his family will be as follows:

Older child	$ 325,000
Younger child	$ 325,000
Wife	$2,750,000

- If instead Ben's will provides that one-half of his estate will be distributed to his children in equal portions and one-half of his estate to his wife, the disposition will be as follows:

Older child	$ 450,000
Younger child	$ 450,000
Wife	$1,700,000
IRS	$ 800,000

Example 5-7 (continued)

- In this circumstance, Ben may provide for a measure of "equalization" by purchasing a $1 million life insurance policy to be owned by an ILIT. If Ben maintains the set aside of the applicable credit amount for his children, the disposition of funds will be as follows:

Older child	$ 825,000
Younger child	$ 825,000
Wife	$ 2,750,000
IRS	$ 0

USE OF QUALIFIED PLAN

The establishment of an ILIT and the associated purchase of life insurance may be an effective way to increase the net inheritance of children and grandchildren. A high net worth individual with substantial funds in a qualified retirement plan, 401(k), or IRA should consider this planning opportunity.

Example 5-8:

- Steve and Kathleen are 68 years old and have an estate of approximately $8 million, with $3,800,000 in Steve's IRA.

- If Steve and Kathleen both die, the $3,800,000 in the IRA passes to the children and will be subject to estate tax (55%) and income tax (15% to 39.6%).

- The amount of estate attributable to the IRA constitutes a deduction for income tax purposes (§691(c)).

- Even so, the effective combined tax rate on the transfer of IRA funds to the children may be 75%, demonstrating that an IRA constitutes a tax-efficient retirement vehicle but a tax-inefficient wealth transfer vehicle.

Strategic Steps

If Steve and Kathleen have sufficient funds to provide for their long-term financial independence and well-being, they may consider taking the following steps:

1. Establish an ILIT as a generation-skipping trust.

2. Have the ILIT purchase a large second-to-die life insurance policy on their lives.

3. Withdraw the necessary amount each year from the IRA to pay the associated income tax and premium.

This strategy can dramatically increase the eventual net inheritance of the children and the grandchildren.

Variation

There is an increasingly popular variation on this theme. Steve and Kathleen may purchase a survivorship life insurance policy (from their personal funds or from IRA funds). The policy is owned by an ILIT. The availability of this liquidity may make it possible to keep the IRA intact after the death of Steve and Kathleen.

The IRA may be structured to pay out benefits over the lifetime of one of the children, **"IRA stretch-out strategy."** The IRA does not terminate upon the death of Steve and Kathleen — it continues to accumulate free of income tax, making the required distributions over the life expectancy of a child.

Caution: Sometimes estate planning attorneys, insurance professionals, and investment counselors do not pay close attention to the attributes of such planning. Generally these plans have two obvious results:

- Plan of withdrawing funds from the IRA to buy a survivorship policy in an ILIT increases the net inheritance of the children.

- Plan decreases the funds available to the parents during their lifetime for enjoyment and security.

This sophisticated planning may result in fees for the estate planning lawyer, substantial commissions for the insurance professional, and/or substantial commissions for the investment advisors. In many cases such planning **is** warranted. The planner must be careful, however, to protect the lifestyle and financial independence of the parents.

SPLIT DOLLAR FUNDING

GENERAL STRUCTURE

For an employee, the payment of the premium on a life insurance policy is sometimes structured in a "split-dollar arrangement." Split-dollar life insurance is generally an agreement to divide the premium payments and the proceeds of life insurance between two or more parties.

The most common split-dollar arrangement is between an employer and employee (or between an employer and an irrevocable life insurance trust to which the employee has transferred rights under a life insurance policy). Under recent private letter rulings, a split-dollar arrangement may be structured among family members, although the income and gift tax consequences are less certain in these private arrangements.

In the traditional form of split-dollar arrangement, the employer pays the "permanent life insurance component" of the annual premium. Generally the employee (or the ILIT established by the employee) pays the balance of the annual premium corresponding to the "term component." If the employer also pays the "term component" of the annual premium, that payment represents taxable compensation to the employee.

Advance

The payment of the premiums by the employer each year represent a "non interest-bearing advance" to the employee (or to the ILIT). The "advance," usually documented in a split-dollar contract, is a legal obligation of the employee (or ILIT).

The employee (or the ILIT) is generally the owner of the policy. The employee-owner executes a collateral assignment, assigning an interest in the life insurance policy to the employer to secure the "advance." If the employee dies, the portion of the life insurance proceeds equal to the cumulated advance is paid to the employer. The balance of the life insurance proceeds is paid to the employee (or the ILIT).

Alternatively, under an endorsement arrangement, the employee endorses all of the ownership rights in the policy to the employer (reserving the right to the balance of proceeds). In effect, the employer owns the policy.

The employer's payments are not deductible. As noted, if the employer pays the entire premium, there is taxable compensation to the employee. This compensation is measured by the cost of term insurance for each year as stated in the IRS Pension Service Table 58 (PS 58).

PURPOSES

The split-dollar arrangement may accomplish several goals by providing:

1. Important fringe benefit and incentive to a valued employee.

2. Method of obtaining life insurance at a reduced cost to the employee (by using employer funds).

3. Reduction in use of the annual exclusion or unified credit if the employee transfers ownership of the life insurance policy to an ILIT.

Example 5-9:

- Permanent life insurance policy on employee Elmer's life is purchased with an annual premium of $26,000.

- If Elmer transfers the entire life insurance policy (including the "permanent component" and the "term component") to an ILIT, then Elmer must make a gift each year to the ILIT of $26,000 to pay the premiums.

- If the payment of the premium is "shared" under a split-dollar contract between Elmer and his employer, so that Elmer pays the $1,000 "term component" and the employer pays the $25,000 "permanent component," then Elmer may make a much smaller gift ($1,000) to the ILIT.

PLANNING ISSUES

Two planning issues must be given particular attention in structuring a split-dollar agreement.

Exit Strategy

If the employee dies, the resolution of the split dollar contract is straightforward. A share of the proceeds equal to the accumulated advances, amount paid by the employer are returned to the employer. The balance of the proceeds is paid to the employee (or the ILIT).

However, if the employee terminates employment, or the policy is terminated, or the split-dollar agreement is otherwise terminated, substantial financial and tax issues may occur.

Example 5-10:

- Jackson, an employee, establishes an ILIT which purchases a $1 million permanent life insurance policy.
- The ILIT enters into a split-dollar arrangement with ABC Company (the employer of Jackson).
- The ILIT pays the PS 58 cost each year of $1,000 and the employer agrees to pay the annual "permanent portion" of the premium which is $31,000. There will be a $31,000 annual "advance" by the employer. In this structure, Jackson may make a gift of $1,000 each year to the ILIT.
- Jackson **dies** at the end of the 11th year when the accumulated advances total $341,000. That amount, $341,000, will be paid to the ABC Company from the insurance proceeds. The balance, $659,000, will be paid to the ILIT (and will not be subject to estate tax in Jackson's estate).
- What if Jackson **retires** in the 11th year of the policy and the parties wish to terminate the split-dollar agreement?
- There are two tax difficulties.
    - Jackson must pay $341,000 to ABC Company to pay off the "advance" debt.
    - If Jackson does not have the $341,000, then the ABC Company may pay bonus compensation to Jackson to provide the funds for the payment of the advance debt.

Often the contemplation of such compensation is structured as a deferred compensation arrangement associated with the rollout of the split-dollar agreement. When the split-dollar contract is signed, the ABC Company also signs a deferred compensation agreement that will pay Jackson, as deferred compensation, the amount of the "accumulated advances."

In such planning modes, the deferred compensation is usually "grossed up" so that it includes the amount necessary to pay the income tax on the deferred compensation. In the above example, Jackson would receive deferred compensation in the 11th year of $568,000, including $341,000 to pay off the advance debt and $227,000 to pay the associated income tax.

Note: The deferred compensation is generally deductible for income purposes to ABC Company. Obviously, the planners must address these financial and income tax issues — the "rollout" strategy or the exit strategy — when the split-dollar contract is considered.

There is a second dilemma. The ILIT owns the life insurance policy (and not Jackson). The ILIT has received the annual advances and the ILIT is obligated to repay the $341,000 debt. To provide funds to the ILIT for that purpose, Jackson must make a $341,000 **gift** to the ILIT. If Jackson has sufficient unified credit remaining he could use it, if not, he has a gift tax due. For large planning cases, the "gift component" of the exit strategy presents hurdles.

Taxable Income Equal to Increase in Equity

Recently the IRS raised additional problems with split-dollar arrangements. In TAM 9604001, the IRS found that the **equity increases** each year in a policy which exceeded the employer's total premiums constituted income to the employee. In the above example, in the sixth year of the policy the ABC Company made a $31,000 advance. The increase in the cash value of the policy between the fifth and sixth year is $40,000. The IRS takes the position that the $9,000 "equity," the amount by which the policy cash value exceeded the employer's premium payment, constitutes **taxable income** to the employee. For life insurance policies which perform well, this increasing taxable income (if the IRS is able to sustain this position) might trigger an earlier "exit" than was otherwise contemplated.

A split-dollar arrangement, then, may be an effective way to provide funding for life insurance. The planner, however, must be particularly alert to the tax issues which may arise on the "rollout" or "exit" from a split-dollar arrangement.

CHAPTER 6

PLANNING WITH CHARITABLE GIVING

INTRODUCTION

Donors to qualified charities receive a deduction for income, gift and estate tax purposes. Split-interest trusts, including charitable remainder trusts and charitable lead trusts, offer donors significant planning opportunities. These trusts have both a charitable beneficiary and a noncharitable beneficiary, may be structured as an annuity or a unitrust for the trust term, result in gift and estate deductions, and, in some cases, income tax deductions.

Another useful vehicle for clients with charitable intentions is the family foundation, an exempt charitable organization under the control of the donor and the donor's family. See Family Foundations, below.

CHARITABLE REMAINDER TRUST (CRT)

A charitable remainder trust (CRT) is an irrevocable trust which provides a defined payment to one or more persons at least one of whom is a noncharitable beneficiary. Upon termination of the interest of all noncharitable beneficiaries, the remainder must be paid to a charity defined in IRC §170(c) or continued in trust for charitable purposes (§664). See Rev. Ruls. 72-395, 80-123, 82-128, 88-81.

ANNUITY TRUSTS AND UNITRUSTS

The two types of CRTs are annuity trusts and unitrusts. The annuity trust (called a CRAT) pays a fixed percentage (at least 5%) of the initial value of the trust assets annually to a noncharitable beneficiary. The unitrust (CRUT) pays a percentage (at least 5%) to the noncharitable beneficiary of the value of the trust assets, recalculated annually.

The annuity trust pays a fixed amount. In the event income is not sufficient, trust principal satisfies the payment. The unitrust pays an amount which may fluctuate, depending on the value of the trust corpus. It may provide for the lesser of the specified percentage or the net income. The unitrust may also provide for a "makeup" payment in future years if net income falls short of a defined percentage. See PLR 9442017, 9511007, 9511029, 9609009, 9711013. Administration of an annuity trust is much simpler than a unitrust.

The initial funding is the only contribution allowed to an annuity trust. Additional contributions may be made to the unitrust. This is the key to the CRT — it is a method of tax-free diversification.

Sample and very simplified trusts have been published by the IRS. See Rev. Procs. 89-20, 89-21, 90-30, 90-31 and 90-32. See also Rev. Rul. 88-81.

INCOME TAX ADVANTAGES

There are two significant income tax advantages to the contribution of property to a CRT. To the extent of the value of the remainder, the contribution qualifies for a charitable deduction for income tax purposes. Further, the CRT may sell appreciated property without recognizing capital gain. This is the key to the CRT — it is a method of tax-free diversification.

This latter advantage is not available if the CRT is required to sell the asset because of a prearranged sale. At what point a prearranged sale or a requirement by the CRT to sell contributed assets occurs has generated much controversy. See *Palmer v. Commissioner,* 62 TC 684 (1974); *Blake v. Commissioner,* 697 F.2d 473 (1982); Rev. Rul. 60-370, 78-197; Notice 94-78, 1994-2 C.B. 555; PLRs 9203005, 9452020, 9452026, 9413020.

MINIMUM CHARITABLE INTEREST

Under the Taxpayer Relief Act of 1997, for CRT transfers made after July 28, 1997, the value of the charitable remainder interest must be at least 10% of the property transferred to the trust. The interest is valued at the time of transfer, determined by the rate in the §7520 valuation tables. Transitional rules also apply [§§664(d)(1)(D), 664(d)(2)(D)].

This limits the use of a CRT in the case of young beneficiaries who are to receive income payments for life or with high payout rates for older beneficiaries. For example, depending upon the §7520 rate, a payment of the minimum amount, 5%, may not qualify for a 21-year-old who is the sole beneficiary to receive income for life. With a husband and wife in their early 30s, with 5% paid for both lives, the CRT may not qualify for a 10% charitable interest remainder.

The '97 Act also added §2055(e)(3)(J) which allows for certain reformations of a trust which does not meet the 10% minimum. This may be needed for testamentary CRTs where the §7520 rate at death cannot be known at the time testamentary documents are drafted.

Classic Use of the CRT

Single Life

Generally, an individual creates a CRT and reserves the right to an annual payment. Often, this is the "annuity payment," or fixed amount each year.

Example 6-1:

- Tim transfers $500,000 worth of appreciated stock into a CRT and reserves the right to receive a 7% annuity each year, namely $35,000 a year.
- The discounted present value of the right to receive the trust assets at the time the trust terminates is allowed as a charitable income tax deduction [§170(a), (c), (f)] and a gift tax deduction [§2522(a), (c)].

Multiple Beneficiaries

In the above example, Tim might reserve the annuity payment for two lives. Therefore, Tim could reserve a $35,000 payment each year for as long as he or his wife, Isabelle, were alive. On the death of the survivor of Tim and Isabelle, or termination of the trust, the remaining trust estate is paid to a charity named in Tim's trust.

Standard CRT provisions

Typically, a CRT has the following elements:

- Irrevocable trust is created by the trust settlor (donor) as a CRT.
- Property is transferred to the CRT (unencumbered by any debt on which the settlor remains liable). A transfer of appreciated property is particularly attractive. See Advantages and Disadvantages below. The trust invests the property and is free to sell nonproductive assets and invest in income-producing property.

- Settlor may serve as trustee.

- Settlor reserves an annual annuity payment (a fixed percentage of the initial value of the trust assets), often for two lives (the settlor and the settlor's spouse). A unitrust amount (a percentage of the value of the trust recalculated each year) may also be used. A fixed term, not over 20 years, may be selected.

- No withdrawal of principal from the CRT is allowed (other than to maintain the annuity amount, 7%). The settlor or the settlor's spouse is entitled only to the annual annuity payment.

- Upon termination, the remaining trust estate is paid to one or more charities.

- CRT is subject to many of the same restrictions as a private foundation, such as restrictions on "self-dealing" (§4941, et seq). See Family Foundations, below. However, "excess business holdings" (§4943) and jeopardy investment provisions (§4944) do not apply to CRTs [§4947(b)(3)(B)].

Again, the sale of any asset by the CRT is not an income tax event. A CRT itself is effectively a charitable trust exempt from income tax, unless it has unrelated business taxable income (§§512, 664(c)). Therefore, the classic use of a CRT is to accomplish a tax-free sale of an appreciated asset.

Estate and Generation-Skipping Taxes

If, in the example above, the CRT is created by Tim's will, there is an estate tax deduction (§2055(c), (e)). There are no generation-skipping tax implications unless Tim names an income beneficiary who is two or more generations below Tim (such as Tim's grandchild, great-grandchild, etc., or a nonfamily member born more than 37½ years after Tim's birth). Use of the CRT for younger beneficiaries is not common and may not work well under the new 10% minimum charitable interest rules, but where you have this circumstance each payment to the beneficiary is a generation-skipping transfer.

See IRS Publications 1457 (annuity) and 1458 (unitrust) for examples of calculations.

ADVANTAGES AND DISADVANTAGES

The following example illustrates the income tax advantage of a CRT.

Example 6-2:

- Tim owns $500,000 of stock with a $50,000 basis.
- If Tim sold the stock, the taxable gain would be $450,000. This amount would be subject to federal capital gains taxation as well as income tax in many states.
- Depending on the year of sale and the rate of state tax, assume approximately $150,000 of income tax. In other words, Tim would be left with $350,000 of after-tax sales proceeds.

With a CRT, however, there is no income tax on the sale. Tim, in the example above, contributes $500,000 of appreciated stock to the CRT. The stock is sold with no capital gains tax and the portfolio is diversified within the CRT. The CRT has $500,000 of proceeds to invest. Tim and Isabelle receive income for life, and Tim's favorite charity, for example, where he has been a board member for 15 years, and to which he wants to make (and may feel as if he is expected to make) a substantial gift, receives the remainder (including all appreciation) at the survivor's death. Tim has the satisfaction of making a major gift to the charity and still providing income for himself and his wife.

Other Advantages

The second advantage is that the settlor receives an income tax deduction (a charitable deduction) in establishing the CRT. In the above example, Tim's charitable deduction would not be equal to $500,000, because the charity would not receive any benefit until both Tim and his wife died. The amount of the charitable deduction is a function of the estimated term of the annual payments and the rate of the annuity payments. A longer estimated term results in a smaller charitable deduction. A higher annual annuity payment results in a smaller charitable deduction.

Finally, in some cases, through the CRT the settlor can diversify investments and obtain income from the diversified investments without reducing their value for payment of tax on the sale of the initial asset. Assume that the $500,000 asset with a $50,000 basis in the above example is one which produces little or no income. With the CRT, a sale of the asset allows transfer of the entire $500,000 into income-producing investments and an additional stream of income to the settlor.

Key Disadvantage

The key disadvantage of a CRT is that the settlor has no access to, or benefit from, the principal (other than principal required to meet the annuity percentage). Therefore, the CRT is well-suited only for the wealthier client who can afford to forfeit all rights to the principal transferred to the CRT.

Example 6-3:

- Tim has a $4 million estate, including a highly appreciated $1 million asset.
- Transferring the $1 million asset to a CRT may make possible tax-free diversification and an eventual transfer to charity.
- Tim retains $3 million of principal to provide for economic reversals, medical expenses, and other needs for principal for his family.
- By contrast, if Tim has a $1,500,000 estate and a highly appreciated $1 million asset, the transfer of the $1 million asset into a CRT is generally not advisable.
- Tim would be left with little principal to provide for long-term economic well-being.

The CRT puts the principal beyond the reach not only of the settlor (in this case, Tim), but also the settlor's family (as an eventual inheritance). If Tim had $4 million estate, established a $2 million CRT, and took no additional steps, the eventual inheritance of Tim's family would be reduced by about $900,000, taking into consideration federal estate tax on $2 million. To offset that reduction, the CRT is often marketed along with a proposal to purchase a substantial life insurance policy. The CRT consultant is often an insurance professional wearing a consulting hat.

Be careful in evaluating these insurance plans.

Example 6-4:

- Settlor and spouse purchase a $3,800,000 life insurance policy with a $76,000 annual premium.
- The charitable remainder trust of $2 million would provide annual income of $100,000 a year which is taxable to the recipient.
- Assuming the client is in a 40% income tax bracket, the charitable remainder trust would produce $60,000 of after-tax income.
- This after-tax income is $16,000 less than the $76,000 a year insurance premium each year.

For many clients, this is not acceptable, even after the amount saved by the income tax charitable deduction is considered. Often, a couple should consider a more inexpensive second-to-die policy to feel comfortable. In any case, the plan's "numbers" must be carefully worked out before the CRT is funded.

OTHER PLANNING IDEAS

Where testamentary CRT provisions exist, and the CRT is funded with income in respect of a decedent from the settlor's estate, the IRD is nontaxable to the trust and to the income beneficiaries (except to the extent of the actual CRT payments to the beneficiaries). See PLR 9634019.

Another use of the CRT is in marital deduction planning in a couple's estate. The annuity or unitrust interest to a spouse qualifies for the estate and gift tax marital deduction, if the spouse is the sole noncharitable beneficiary (§§2056(b), 2523(g)). With this technique the settlor can provide income to the surviving spouse, and receive deductions from estate taxes without any additions to the spouse's taxable estate (other than unexpanded income).

Still another planning opportunity may exist for older clients looking at income tax upon distribution of their IRAs, 401(k)s, or other qualified plans, or those concerned about estate tax upon the value of such plans. By taking a lump sum and keeping intact the plan assets (not reduced in value by payment of income tax), they could avoid the annual calculations of life expectancy, obtain continued income stream from the CRT, remove substantial value from their estate thus reducing estate taxes, and make a valuable gift to the charity or charities of their choice.

Sensible Technique

In short, the CRT is a sensible and powerful estate planning technique for a person with a large estate, particularly one with highly-appreciated assets. The major disadvantage is that the trust settlor-donor gives up the right to draw on the principal in the CRT. This may reduce the lifetime financial security and flexibility of the settlor, but that may not be an issue if the settlor has a very large estate. This transfer also reduces the eventual inheritance of the family. This may not be a problem if the settlor is:

- Willing to purchase life insurance and is insurable,
- Wants in any event to make a significant gift to charity, or
- Is simply willing to reduce the inheritance of the children and grandchildren in favor of the eventual charitable beneficiaries.

CHARITABLE LEAD TRUST (CLT)

A charitable lead trust (CLT) also provides the settlor with both a federal income tax deduction and a federal gift tax deduction and avoids inclusion of the trust corpus in the settlor's gross estate upon death. It shares many of the same advantages and disadvantages as the CRT discussed above. It can be thought of generally as the reverse of a CRT. The CLT provides an income payment to the charity and a remainder to the child or grandchild of the donor (or to any other person selected by the donor).

General Structure

The general structure for a CLT trust is:

1. Settlor creates an irrevocable trust and funds it with income-producing assets.
2. For a term of years, the trust pays either a guaranteed annuity amount (i.e., a percentage of the initial trust value of the trust assets) or a guaranteed "unitrust" amount (i.e., a percentage of the value of the trust, as that value is recalculated each year) to a charitable organization which the settlor selects.
3. Settlor has no access to principal.
4. At the termination of the trust, the trust assets are paid out to the remainderman selected by the settlor, such as the settlor's child or grandchild.

5. A CLT, like a charitable remainder trust, is subject to most of the "private foundation" restrictions, including self-dealing, and restrictions on the character of the trust's investments. See generally, §4941, et. seq. summarized in Family Foundations, below. Jeopardy investments and excess business holdings restrictions apply to CLTs unless they meet certain criteria, in general, where the charitable interest is less than 60% and all of the income but none of the remainder is devoted to charity (§4947(b)(2)(A)).

GIFT AND ESTATE TAX CONSEQUENCES

The transfer of assets to fund a CLT is a taxable gift. The settlor, however, has a charitable gift tax deduction equal to the value of the charitable "lead" interest (§2522(c)(2)(B)).

The value of the charitable lead interest is determined under IRS tables and depends on the value of assets transferred, the amount of the annuity or unitrust payment made to the charity, and the applicable federal discount rate at the time the trust is funded.

Example 6-5:

- Amount transferred to a trust is $1 million, the annuity amount paid to a charity for a 15-year term is 9% (i.e., $90,000 per year), and the applicable federal discount rate is 8%.
- Value of the charitable lead interest (i.e., the amount of the gift tax deduction) would be $793,080. So, the amount of the taxable gift (i.e., the value of the remainder interest) would be $206,920, which is only about 20% of the total value of assets placed in trust.
- Further, if the trust value increases by a rate more than 9% per year (i.e., by an amount more than necessary to pay the charity its guaranteed annuity), all of the "excess appreciation" passes to the remainderman free of transfer taxes.

Thus, CLTs are particularly useful for assets which will appreciate at a higher rate than the charitable payout.

Trust assets are not part of the gross estate of the donor, regardless of how much those assets may have appreciated by the time of the grantor's death. See generally, PLRs 9224029, 9247024. If the donor funds the CLT at death rather than during lifetime, the donor would be entitled to an estate tax deduction calculated in the same way the gift tax deduction is calculated in the case of CLT established during lifetime.

INCOME TAX CONSEQUENCES AND GRANTOR TRUST CLT

The typical charitable lead trust does not permit the settlor an income tax deduction. However, a CLT does remove income from the return of the grantor by diverting it to the charity.

An exception, is the grantor CLT. The CLT may be structured as a "grantor trust" under federal income tax principles, thus allowing the settlor an income tax deduction **in addition to** the gift tax deduction described above (§170(f)(2)(B)). Grantor trust status is met (without affecting the right to a gift tax deduction) by including in the trust a special administrative provision permitting the settlor to substitute assets of equivalent value, a power which, in general, would never be used. See §675(4).

The settlor is then entitled to a charitable income tax deduction at the time the trust is funded equal to the present value of all payments to be made to the charity. The use of that deduction is generally limited to 30% of the settlor's adjusted gross income (20% in certain cases where the trust is funded with capital gain property), although any part of the deduction which as a result of this limitation cannot be used in the year the trust is funded may be carried over and deducted in any of the succeeding five taxable years [(§170(b), (d))].

Recapture

With a grantor trust, the settlor (or "grantor"), rather than the trust itself is taxable on the income earned each year by the trust, even though some or all of that amount is being paid to a charity (§671, et. seq.). Thus, in effect, the charitable income tax deduction the settlor receives at the time the trust is funded is "recaptured" over the life of the trust, by the income tax that is paid by the settlor each year.

Further, if the settlor dies before the end of the charity's income term, the remaining amount of the charitable deduction not previously recaptured will be recaptured at that time (§170(f)(2)(B)). One way to reduce the effect of this "recapture" may be to invest trust assets in income-producing investments which are not subject to federal income tax, such as tax-free municipal bonds, to the extent this is allowable as a prudent investment for the trust. The settlor would still receive a charitable deduction when the trust is funded, but would not pay tax on the income used to fund the charitable payment each year. A testamentary charitable lead trust, however, cannot be a "grantor trust" for federal income tax purposes, and, therefore, no charitable income tax deduction can arise on the creation of a testamentary trust. See PLR 7815017.

GENERATION-SKIPPING TAX (GST)

If the remainderman at trust termination is the settlor's grandchild or great-grandchild, the termination of the trust and the distribution of trust assets will be subject to the 55% GST rate (§2612(a)). The value of the trust subject to the GST is measured at the time the trust terminates. Any future appreciation in the value of the trust that is not paid out to the charity will be subject to the GST (§2622).

GST liability can be reduced through an allocation of the settlor's $1 million GST exemption (to the extent the grantor has not already used that exemption for other purposes).

FAMILY FOUNDATIONS

For clients who want to leave substantial assets at death or during their lifetimes for charitable purposes, the use of a family foundation can fit well into a plan of distribution. The family foundation can also serve as training for other family members, especially children and grandchildren, in the prudent use of assets for charitable purposes. The family members also can benefit from participation in the client's charitable plans and from association with the charitable benefits conferred by the foundation.

BASIC RULES

A private foundation is an organization established by one or more individuals to engage in charitable work. See Reg. §1.509(a)-1. A private foundation may be established to receive lifetime gifts or to receive gifts through an estate. In many estate plans, the family foundation is the charitable beneficiary which receives the trust assets at the termination of a CRT.

Tax-exempt status is gained by organizing and operating a nonprofit corporation (or trust) exclusively for charitable, educational, scientific, literary or religious purposes. The entity typically used is a corporation or trust formed under state laws dealing with trusts or nonprofit corporations. To the extent permitted by state law, the donor or the family can control the foundation. Family members are usually the officers and directors or trustees. The foundation is usually named after the donor. The board of directors or trustees usually meets at least annually and makes major decisions, such as which charities to fund that year, consistent with any restrictions the donor placed in the articles, bylaws or trust.

Two Tax Objectives

There are two primary tax objectives. The first objective is to qualify the organization as "tax-exempt" under §501(c)(3). This is the income tax exemption, with the result that the normal corporate (or trust) income tax rates do not apply to the foundation's income or gain. The second objective is to qualify the organization as one to which contributions are deductible, both for lifetime and for testamentary gifts. This requires compliance with the federal tax requirements not only for income tax deductions (§170), but also for gift tax (§2522) and estate tax (§2055) deductions.

Status as a §501(c)(3) organization requires that no part of the "net earnings" can "inure" to the benefit of any private individual. No distribution of the organization's assets may be made to its members upon dissolution; thus, all gifts to the foundation are irrevocably dedicated to charitable purposes.

PROCEDURES

Procedurally, the organizational documents (with a nonprofit corporation, for example, articles of incorporation and bylaws) are filed with the IRS, together with a "Form 1023" application (Application for Tax-Exempt Status), Form 8718 (User Fee) and SS-4 (Application for Employer Identification Number). Among other things, the application describes the organization's sources of financial support, any planned fund raising activities, any proposed future activities, the names and addresses of the directors or trustees, the identity of substantial contributors, and a three-year projection of contributions, distributions, income, and expenses.

An IRS determination letter will state that it recognizes the organization as a "private foundation" for federal tax purposes. This characterization applies if the organization is not publicly supported. Unless contributions, membership fees and other receipts from other than "disqualified persons" are normally more than one-third of the organization's support, the publicly supported test is not met.

The term "disqualified persons" would include any contributor of $5,000 or more, as well as foundation directors, officers, trustees and managers. Related corporations, partnerships, estates and trusts are also within the definition. Because the donor will be the primary (if not the sole) source of its support, the family foundation would be treated as "private."

DEDUCTIONS

Cash gifts are deductible up to 30% of the donor's contribution base (defined as adjusted gross income, determined without regard to any net operating loss carryback). Any deduction not usable in any year would carry over, subject again to the 30% ceiling, to each of the five succeeding taxable years.

A limited exception allows gifts of publicly traded stock to a private foundation to be deducted at fair market value ("qualified appreciated stock"). (§170 (e)(5)). The exception has been used for donors with low-basis stock donated to a foundation. The deadline on this provision has been extended several times but the version adopted by Congress in 1998 has no termination date.

In applying these various limitations on deductibility, contributions to private foundations are considered first (which may have an adverse effect if the donor is also making direct gifts to public charities subject to the 50% limitation).

Testamentary gifts to a private foundation, like gifts to a public charity, result in a federal estate tax charitable deduction. Potential high-tax items which constitute income-in-respect-of-a-decendent, such as qualified retirement benefits, are ideal for this purpose.

EXCISE TAXES

A private foundation is subject to a series of excise tax provisions. Most of these provisions will, however, be of only potential rather than actual application. The one provision that will always apply is the 2% tax on the foundation's annual net investment income (which includes net capital gains, even though the foundation is income-tax exempt). The actual tax cost will be minimal. This tax is intended to fund the IRS's cost of ensuring compliance with the private foundation rules and regulations. There are five other private foundation rules that prohibit certain types of activities and investments. They are discussed in Prohibited Transactions, below.

TYPES OF PRIVATE FOUNDATIONS

Certain private foundations are treated more like public charities with higher contribution base limitations. They include private operating foundations (which create and conduct their own charitable activities), pooled-fund foundations or pass-through foundations. These are more difficult set up and administer and are less often used, at least by individual clients, than the private nonoperating foundation. Only the private nonoperating foundation is discussed here.

PROHIBITED TRANSACTIONS

Self-Dealing

Although the donor may properly control a private foundation, the donor, members of the donor's family, and other "disqualified persons" may not engage in "self-dealing." See §4946 for definitions.

"Self-dealing" includes:

- Loans,
- Payments or excessive compensation,
- Preferential availability of services,
- Purchases or sales,
- Leases, and
- Diversions of income to disqualified persons.

A donor may appoint family members to the Board of Directors or Trustees and management of a private foundation but all transactions between the foundation, the donor and the donor's family must be reviewed very carefully. Even an apparently "fair" transaction may constitute "self-dealing" (§4941).

Example 6-6:

- Grandfather Jones creates the Jones Family Foundation and contributes land and stock.
- He later decides to buy part of the land from the foundation.
- He is willing to pay whatever a good faith appraisal shows is the current market value or to match any other offer.
- This purchase would be "self-dealing" under the Code definition.

Self-dealing results in a tax equal to 5% of the amount involved for the self-dealer and 2½% for the foundation manager involved in the acts. If the act of self-dealing is not corrected within a

specific time, a tax equal to 200% of the amount involved may be imposed on the self-dealer and 50% on the foundation manager.

Annual Distribution

Generally, a private foundation must distribute an amount equal to its "minimum investment return" every year (§4942). The minimum investment return generally is equal to 5% of the fair market value of certain assets of the private foundation. This distribution requirement is very significant. Accordingly, a foundation should take necessary precautions to ensure that it has sufficient liquid assets to comply with this requirement.

Qualifying distributions, for purposes of the minimum distribution requirement, generally include grants to independent public charities, as well as foundation administrative expenses and the excise tax on investment income. For grants to public charities, the foundation must assure itself of the public charity status of the donee before making a donation.

Two common ways of ascertaining whether a prospective donee is a publicly supported charity are:

1. Asking the organization for proof of its tax classification by the IRS, and

2. Checking IRS Publication 78, "Cumulative List of Organizations Described in Section 170(c) of the Code."

Distributions for each taxable year must be made by the end of the following taxable year. The distributable amount will, of course, change each year. *It is recommended that, when the* accountant prepares the foundation's Form 990-PF each year, an officer of the foundation requests the accountant to notify the foundation in writing of the amount which must be distributed by the end of the tax year.

If the foundation does not make the required annual distributions, it will be subject to an initial tax of 15% of the undistributed income and a 100% tax if the failure is not corrected within a specific period.

Excess Business Holdings

A private foundation is prohibited from retaining certain excess business holdings (generally, any interest in a corporation, partnership or other business entity which, when aggregated with the interests of "disqualified persons," exceeds 20% of the interests in such entity) (§4943).

Example 6-7:

- Grandfather Jones contributes stock to the Jones Family Foundation which consists of 10% of Grandfather Jones's business.
- Grandfather Jones now owns 5% and his wife owns 5% and his son owns 5%.
- The foundation is prohibited from holding the stock because the foundation and disqualified persons own more than 20% of the stock of the business. The foundation owns 10%, Grandfather Jones owns 5%, his wife owns 5%, and his son owns 5%.

Speculative Investments

A private foundation also may not invest in unduly risky or speculative ventures which jeopardize the charitable purpose of the private foundation (§4944). A "prudent trustee" standard applies in determining whether the foundation has made poor investments.

Substantial excise taxes may be imposed if the foundation violates either the excess business holdings prohibition or the speculative investment prohibition.

Unrelated Businesses

Unless a business is in furtherance of and related to the organization's charitable purpose, a §501(c)(3) organization generally is prohibited from carrying on a trade or business as a substantial part of its activities.

Even if the businesses were insubstantial (so that the basic tax exemption was not at risk), if it were **unrelated** to the charitable purpose, it would nevertheless create "unrelated business taxable income" or "UBTI." The result would simply be to tax this business income as if the foundation were a regular corporation, paying a maximum 35% federal tax plus a state tax on the net business income. See IRC §§502, 512, 513.

For example, a charity which benefits medical research and which sells holiday cards as a fund-raiser probably has UBTI. However, a charity which benefits disabled artists and sells their artwork on greeting cards may not incur UBTI because the business is related to the charitable purposes.

Taxable Expenditures

The foundation should not make any grants for noncharitable purposes. These include specific prohibitions against:

- Grants for lobbying or propagandizing or to influence elections or conduct voter education campaigns;
- Grants to individuals, except as specially permitted; and
- Grants to organizations other than public charities unless the foundation closely monitors the grantee's use of the funds (§4945).

An initial tax of 10% of the amount of the improper grant is imposed on the foundation and 2½% on any foundation manager unreasonably agreeing to the expenditure. The tax is increased to 100% and 50%, respectively, if not timely corrected.

Debt

The foundation should not incur debt without first obtaining legal advice. The presence of any debt may cause the foundation's income to be taxable as "unrelated debt financed income" (§514).

FEDERAL FILING REQUIREMENTS

The filings for a private nonoperating foundation in many cases are relatively simple. Every year an officer of the foundation must file a Form 990-PF with the IRS for the prior tax year, along with payment of any excise tax on net investment income.

Where the calendar year is used as the tax year, Form 990-PF must be filed on or before May 15 of the following year. Form 990-PF consists of financial statements in IRS format, calculations regarding the 2% excise tax on net investment income, and calculations which may reduce the tax to 1%. Additionally, Form 990-PF asks questions about the foundation's activities and compensation of foundation managers. Finally, the form calculates whether the foundation has met its annual minimum distribution requirements.

Information reported on Form 990-PF, including all attachments, is public information. In fact, the foundation must advertise in a newspaper having general circulation in the county in which its principal office is located stating that Form 990-PF is available for inspection at the foundation's principal office during regular business hours by any citizen who requests inspection within 180 days after the date the advertisement is published.

If engaged in a trade or business unrelated to its charitable purpose (or subject to certain debts), the foundation may be taxed on income from such unrelated trade or business activities. This tax is reported on Form 990-T.

TERMINATION OF PRIVATE FOUNDATION STATUS

A private foundation is subject to taxation if it abandons its private foundation status unless it:

- Converts to a public charity and operates as such for five-years,
- Terminates its existence by giving all net assets to any public charity with a five-year operating history, or
- Merges with other existing private foundations.

CONCLUSION

The family foundation is an ideal way to create a fund to make current charitable gifts. Lifetime gifts obviously give one the satisfaction of seeing the family foundation in operation, as well as a clearer insight whether the foundation is an appropriate vehicle to receive a substantial gift at death. If the foundation does not work, there is always the "out" of terminating it and distributing all assets to public charities.

IRS FORMS

IRS Forms SS-4, 990-PF, 990-T, 1023 and 8718 can be found in the Appendix on page 155.

CHAPTER 7

PLANNING FOR CLOSELY HELD BUSINESSES

QUALIFIED FAMILY-OWNED BUSINESS (QFOB)

$1,300,000 DEDUCTION

The Taxpayer Relief Act of 1997 adopted a family-owned business (QFOB) exclusion for estate tax purposes. Under IRC §2033A, the executor of the estate of a U.S. citizen or resident could elect special treatment for a qualified family-owned business interest to exclude $1,300,000 of property if such property is qualified family-owned business interests of the decedent.

The 1998 Reform Act changed the provision from an exclusion to a deduction and it is now set forth at §2057. The deduction is coordinated with the unified credit. If more than 50% of the estate consists of a qualified family-owned business interest, the executor may elect to deduct the value of the interest from the gross estate. The maximum deduction is $675,000; it is coordinated with the unified credit so that the combined deduction and unified credit may equal but not exceed $1,300,000.

Key Requirements

The key requirements for the §2057 qualified family-owned business deduction are:

1. The decedent was a citizen or resident of the United States.

2. The adjusted value of the qualified family-owned business interests (including QFOB interests previously transferred by gift) exceed 50% of the adjusted gross estate.

3. During the eight-year period ending on the decedent's death there were periods of at least five years during which those interests were owned by the decedent or a member of the decedent's family and there was "material participation" by the decedent or a member of the decedent's family.

4. The qualified family-owned business interests passed to a "qualified heir" — a family member or any active employee who has been employed by the trade or business for a period of at least ten years before the decedent's death — who continues to materially participate in the operation of the business.

Recapture

Section 2057(f) provides for recapture. There is additional estate tax imposed if within ten years after the date of the decedent's death and before the date of the qualified heir's death:

- Material participation requirements are not met, or
- Qualified heir disposes of any portion of a qualified family-owned business interest.

If the additional estate tax is imposed in years one through six, federal estate tax equal to 100% of what otherwise would have been the estate tax (plus interest).

If the recapture occurs thereafter, the applicable percentage is:

Year 7	80%
Year 8	60%
Year 9	40%
Year 10	20%

Although it carries many rigid technical requirements, §2057 may emerge as an excellent planning tool for a family with a closely held business.

PLANNING CONSIDERATIONS

Credit Shelter Trust

Under traditional estate planning documents, assets which qualify for the family-owned business exclusion generally will be allocated to the Credit Shelter Trust. Most wills "back in" to the marital deduction – providing the marital deduction share will be equal to the **minimum amount** necessary to make the entire estate **free of federal estate tax**, after taking into account other credits and exclusions.

The balance of the estate (including the amount protected by the unified credit) is allocated to the Credit Shelter Trust.

Example 7-1:

- Hank is married with children. He dies in 1999 with an estate of $1,600,000 consisting of publicly traded stocks and bonds. His will adopts traditional Credit Shelter Trust planning providing the marital deduction share will be equal to the minimum amount required to render the estate nontaxable.
- The marital deduction share shall be distributed to the QTIP Trust. The balance of the estate shall be distributed to the Credit Shelter Trust.
  - The minimum amount required to render the estate nontaxable is $950,000.
- There will be $950,000 allocated to the QTIP Trust and $650,000 allocated to the Credit Shelter Trust.

Example 7-2:

- George has an estate value and a will identical to Hank. George dies in 1999 and his estate consists of a family farm valued at $1,400,000 and $200,000 of cash.
- With respect to the marital deduction share, the minimum amount necessary to render the estate nontaxable is $300,000.
- Therefore, $300,000 (presumably $200,000 of cash and a $100,000 interest in the family farm) will be allocated to the QTIP Trust.
- Further, $1,300,000 of interests in the family-owned farm will be allocated to the Credit Shelter Trust.
- **Note:**

  The Credit Shelter Trust must be a "qualified heir" with material participation by a family member. Presumably, the family member must be the trustee of the Credit Shelter Trust or must otherwise play an active management role.

Pre-Death Leasing

Historically under §2032A, controversy arose whether renting land under a cash rent or a share lease constitute material participation. More than half of U.S. farmers, after retirement, rent their land. Since an amendment to the law in 1981, pre-death **cash rent leasing** has been accepted as material participation for §2032A special use valuation unless the lease was to a tenant who was not a member of the decedent's family.

The family-owned business deduction of §2057, however, refers repeatedly to "business" and "trade or business" suggesting that Congress intended to provide relief for owners of **active** businesses. The 1998 Reform Act clarified that assets leased under cash rent leases to family member who are materially participating may be eligible for the family-owned business deduction. Assets leased under nonmaterial participation share leases with minimal involvement may also not qualify for eligibility. Therefore, retired farmers should proceed carefully with **leases** in order to assure qualification of the farm assets as a qualified family-owned business (QFOB) for purposes of §2057.

Post-Death Leasing

This same issue applies in the post-death recapture period (10 years after death). There is a two-year grace period from the special use valuation arena which is to allow cash rent leasing only in the two-year grace period immediately following death.

In a letter to Congress, the Joint Committee on Taxation states: "farmland that originally qualified for the family-owned business exclusion will not be subject to recapture if the heirs cash lease the farmland to a member of the decedent's family who operates a business on the land." Though that is a favorable indication, this remains an unresolved area.

Gifts

Sometimes the owner of a family-owned business will be better served to make gifts of non-QFOB assets in order to promote qualification for the $1,300,000 deduction.

Example 7-3:

- Beulah, a widow, has an estate of $2,050,000. Of that estate, $1 million consists of QFOB assets.
- If Beulah makes a gift of $150,000 of QFOB assets to her children under the annual exclusion and then dies, her estate will not meet the 50% ownership test.

(continued)

Example 7-3 (Continued):

- The estate will consist of $2,050,000 of assets of which $1 million is considered QFOB assets.

- Keep in mind that the value of QFOB gifts are aggregated for this purpose.

- Alternatively, if Beulah makes a gift of $150,000 of portfolio assets and dies, her estate will meet the 50% ownership test.

  - The estate will consist of $1,900,000 of which $1 million is held in QFOB assets.

It should be emphasized that gifts of QFOB assets are "pulled back" into the estate for purposes of making the 50% ownership determination but gifts of non-QFOB assets are not "pulled back" into the estate for this purpose. (That is why Beulah's estate and QFOB assets did not decrease in the above example.)

SPECIAL USE VALUATION

VALUATION OF CERTAIN FARMS, CLOSELY HELD BUSINESSES AND REAL PROPERTY

A special valuation is allowed for certain property. Qualified real property is valued for the use under which it qualifies (and not the actual fair market value). The property must represent a closely held family business interest and must pass to a member of the family who materially participates in its operation.

Furthermore, the decedent must have been a U.S. citizen or a resident, the executor of the estate must elect the application of §2032A and file the required Refunding Agreement. The aggregate reduction in fair market value was **limited** for any one decedent to no more than **$750,000** [§2032A(b)(2)]. After 1998, the $750,000 may be adjusted for inflation [§2032A(a)(3)]. In 1999, the limit for this special valuation is **$760,000** (Rev. Proc. 98-61)

Definitions Under Section 2032A

"Qualified use" means the devotion of property to use as a farm for farming purposes or use in a trade or business [§2032A(b)(2)].

"Qualified real property" means real property located in the U.S. which was acquired from or passed from the decedent to a qualified heir and, on the date of the decedent's death, was being used for qualified use by a member of the decedent's family, but only if:

- Fifty percent or more of the adjusted value of the gross estate consisted of the adjusted value of real or personal property which meets the above test.

- Twenty-five percent or more of the adjusted value of the gross estate consisted of the adjusted value of real property (not personal property) which meets the requirements of those tests.

- During the eight-year period ending on the decedent's death there have been periods of at least five years during which such real property was owned by the decedent or a member of the decedent's family and used for a qualified use and there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business.

- Such real property is designated in the refunding agreement.

"Material participation" is determined in a manner similar to that used for the purposes relating to net earnings from self-employment [§1402(a)].

"Qualified heir" is a member of the decedent's family who acquired property or to whom the property passed from the decedent. If the qualified heir disposes of the interest in qualified real property to any member of his family, then that member of his family is treated as the qualified heir with respect to that interest. A member of the family means an ancestor, spouse, lineal descendant, lineal descendant of that individual spouse or parent of such individual, and spouse of any lineal descendant.

"Active management" means the making of management decisions of a business other than daily operating decisions.

Note: Many definitions in §2032A also apply to QFOBs under §2057.

Recapture

The benefits of special use valuation are recaptured if within ten years after the decedent's death and before the death of a qualified heir, the qualified heir disposes of any interest in the qualified real property other than to a member of his family or the property ceases to be used for its qualified use.

The qualified heir is personally liable for any amount which must be refunded under the ten-year rules and may post a bond in order to be discharged from personal liability.

The qualified heir may begin to use the qualified real property within two years after the decedent's death and no tax is imposed by the failure of the qualified heir to use the property before that date. The ten-year period is then extended by the period of time between the decedent's death and the date (within the two-year grace period) when the qualified heir begins to use the property.

Valuation

Farms are valued by dividing the excess of the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm over the average annual state and local real estate taxes for such comparable land by the average annual effective interest rate for all new federal land bank loans. The average annual computation is made on the basis of the five most recent calendar years and ending before the date of death.

If there is no comparable land from which the average annual gross cash rental may be determined, but there is comparable land from which the average net share rental may be determined, average annual net share rental may be substituted for average annual gross cash rental. Net share rental is the value of the produce received by the lessor of the land on which the produce is grown over the cash operating expenses of growing such produce which under the lease are paid by the lessor.

Factors

Where the method described above is not used for valuing farms, then the following factors are applied in determining the value of qualified real property:

- Capitalization of income which the property can be expected to yield for farming or closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration and similar factors;

- Capitalization of the fair rental value of the land for farm land or closely held business purposes;

- Assessed land values in a state which provides a differential or use value assessment law for farm land or closely held businesses;

- Comparable sales of other farm land or closely held business in the same geographical area far enough removed from the metropolitan or resort area so that non-agricultural use is not a significant factor in the sales price; and

- Any other factor which fairly values the farm or closely held business value of the property.

PRACTICAL USE

The special use valuation is particularly applicable to a farm on the outskirts of a metropolitan area or land otherwise well-suited for non-agricultural uses. In effect, §2032A permits the estate to value the farm at its "special agricultural use" and not at the "development value." The estate is permitted to include the real property in the gross estate at a value less than the price that would be paid by a willing buyer.

PLANNING CONSIDERATION

The law does clearly permit cash rent leasing to a family member without disqualifying family farm assets from special use valuation under §2032A. As with §2057, the planner must be careful whether gifts to family members will cause a future problem with respect to qualification to special use valuation.

It should be noted that the IRS requires strict technical compliance with the rules under §2032A. The administrative burdens associated with qualification are often substantial.

SECTION 6166 DEFERRAL OF TAX

Section 6166 applies to estate taxes and to a limited extent to the generation-skipping tax. Under §6166, the estate tax attributable to a substantial interest in a closely held business may be paid in two to ten equal annual installments.

For the estate tax attributable to the first $1 million in taxable value of a qualified closely held business which is included in the estate, the applicable interest is 2% (§6166(b)). This $1 million will be indexed for inflation and rounded to the next $10,000 under the Taxpayer Relief Act of 1997. The interest on the remaining tax is payable at 45% of the underpayment rate [§6601(j)].

The first installment of a §6166 deferral of tax payment can be made on a date selected by the executor not more than five years after the date prescribed in §6151(a). The estate tax may be spread over a period as long as 14 years from the decedent's death. During the first five years only interest must be paid.

Section 6166 applies to corporations, partnerships and sole proprietorships.

KEY REQUIREMENT

The key requirement is that the interest in the closely held business must exceed 35% of the decedent's adjusted gross estate for estate tax purposes.

The election for a §6166 deferral is made upon the estate tax return or on the last date of the extension of time for filing the estate tax return granted.

Although §6166 permits deferral, it is used less frequently than might be expected. Many of the farms and closely held businesses which qualify for the deferral of estate tax under §6166 produce relatively little distributable (dividend) income. Section 6166 provides for the postponement of the estate tax but not for its elimination. Often the period of deferral does not make possible the accumulation of sufficient funds to pay the estate tax distributable to the farm or closely held business.

CLOSELY HELD BUSINESS – INSURANCE PLANNING

LIQUIDITY NEEDS

For many families the closely held business represents a substantial share of their wealth.

Example 7-4:

- Mary is a surviving spouse with a masonry business worth approximately $5 million. She has additional assets of $1 million.
- She and her son, Todd, her only child, operate the business.
- If Mary dies in 2000, $1,300,000 may be excluded under the §2057 protection. Even so, there will be approximately $4,700,000 subject to estate tax, resulting in estate taxes of approximately $2,300,000.
- If Mary's other assets (residence, personal property, portfolio assets) are sold, there will still be a cash shortfall of approximately $1,300,000.

In the domain of the closely held business, it is advisable to purchase insurance to provide for the eventual payment of estate tax — so that the family can preserve the family business. If Mary in the above example purchases a $1,500,000 policy on her life, the $1,500,000 of proceeds will be subject to estate tax in her estate. Manifestly, this is a situation where the policy should be owned by an irrevocable life insurance trust (or possibly by Todd, depending on the circumstances).

EQUALIZATION AMONG CHILDREN

In Chapter 5, the equalization issue was addressed in the context of insurance planning. It bears repeating. For children who are not interested in participation in the family business, it may not be advisable to transfer equity interests to them and make them shareholders or partners with the child or children who are actively conducting the business. Making testamentary transfers of interests in the family business to all children may generate significant family conflict. Conversely, transferring the bulk of the estate to the one child who is conducting the family business may effect a significant inequity.

Example 7-5:

- Dan and Doris have a total estate of $3 million, including a closely held business with a value of approximately $1,400,000.
- Dan and Doris have three children, a son who works in the business and two daughters who live out-of-state.
- If Dan and Doris die in 1999 and 2000 with A/B planning, approximately $1,275,000 will be shielded from estate tax (assuming the business exclusion does not apply). This will leave approximately $1,725,000 subject to estate tax, resulting in an estate tax of approximately $740,000. Assuming the business is maintained intact, there would be approximately $760,000 of net assets for distribution (other than the family business).
- If the son's entire inheritance is composed of interests in the family business, then each daughter will inherit approximately $380,000 of spendable assets and approximately $373,000 of stock in the family business which may be a "worthless asset."

Three Alternatives

There are at least three alternatives the family in the above example may consider:

1. Purchase of a life insurance policy, particularly a second-to-die life insurance policy, to be paid to the daughters — helping to equalize the estate distribution.
2. If possible without a severe income tax result, distribute business real property to the daughters (who may then lease the real property to the brother's family business).

3. Grant a "put" right to each daughter — giving each daughter the right to sell at least part of the stock in the family business to the brother. The associated sale is often structured with a relatively modest down payment and a secured promissory note. It may provide more "spendable funds" to the daughter but it obviously can dissolve into family tensions. If the business goes through a difficult period, do the sisters foreclose upon their brother?

EQUALIZATION AND REAL ESTATE IN A C CORPORATION

In this equalization context, it may be useful to sound a common income tax planning theme: it may be dangerous to own real estate in a C corporation.

Example 7-6:

- Glenda establishes a C corporation and begins a retail lighting business. The C corporation purchases the building and showroom. The value of the real estate appreciates substantially.
- It may be difficult for Glenda and her three children to capture the value of the real estate by sale.
  - Sale of the appreciated real estate by the C Corporation will trigger double taxation (corporate income tax on the sale and individual income tax on the distribution of the proceeds as dividends).
- Similarly, it may be difficult to distribute the appreciated real estate to the shareholders without triggering individual income tax.

Tax Dilemma

This tax dilemma in the above example may restrict Glenda's estate planning attempt to provide for an equal inheritance to her children, one of whom is active in the business. The retail business, independent of the real estate, has a value of $1 million and the appreciated real estate has a value of $2 million.

If in the establishment of the company the operating business had been incorporated as a C corporation and the real estate had been purchased (and leased to the C corporation) by a partnership or limited liability company, then the equalization of the estate might be simple and relatively painless from an income tax point of view.

Glenda's estate plan can provide for the disposition of the operating business to the active child and the transfer of the pass-through real estate entity to the other two children. However, the ownership of the real estate by the C corporation will significantly impede Glenda's attempt to transfer the operating business to one child and a "spendable inheritance" to the other two children. With the real estate in the C corporation, the estate plan may produce family disharmony.

BUY-SELL AGREEMENT

The continuity planning for an owner of a closely held business often involves a buy-sell agreement. §2703). Commonly, the agreements are structured as one of two types:

Redemption-Type Agreement

The entity (the corporation, partnership, or limited liability company) agrees to purchase the equity interest of the deceased owner.

Cross-Purchase Agreement

Each of the surviving individual equity owners agrees to purchase a prorata portion of the deceased owner's equity interest.

LIFE INSURANCE

If the buy-sell agreement provides that the deceased owner's estate sells for a small amount of cash and a promissory note, significant economic uncertainty for the decedent's family may occur. If the note is secured by a mortgage interest in the business property, it may make necessary working capital borrowing too difficult for the business. The business may fail. The economy may face hard times.

Accordingly, it is often advisable that the entity (in a redemption-type agreement) or the individual owners (in a cross-purchase type agreement) purchase life insurance to create reliable and liquid funds available for the purchase of the deceased owner's equity interest.

S CORPORATION ISSUES

A corporation may be disqualified as an S corporation if the shareholders do not meet certain statutory requirements. Only certain types of trusts qualify to be shareholders of an S corporation.

These include limited voting trusts, testamentary trusts and grantor trusts which are limited in duration, QSSTs, and ESBTs.

QSST

The qualified subchapter S trust (QSST) may be a shareholder in an S corporation. A QSST must have only one beneficiary during the life of the current income beneficiary who must be a citizen or resident of the U.S. If the trust terminates during the life of the beneficiary, then all of the assets must be distributed to the beneficiary. The beneficiary must elect QSST treatment for the trust.

A QSST may be structured so that it qualifies for the gift tax and estate tax marital deduction as a QTIP (qualified terminable interest property trust).

ESBT

The electing small business trust (ESBT) was recognized as an eligible S corporation shareholder under the Small Business Job Protection Act of 1996. [§1361(e)]

The ESBT must meet three main requirements:

- All trust beneficiaries must be individuals or estates who are eligible to be S corporation shareholders. (A charity may hold a contingent remainder interest.)
- No interest in the ESBT may be acquired by purchase. (Purchase is defined as any acquisition where the basis is determined under §1012.)
- The ESBT must elect to be a small business trust.

The portion of an ESBT which consists of S corporation stock pays income tax at the highest rate for trust and estate income (otherwise imposed at $8,100), except for its capital gain [§641(d)]. None of the items of income, loss, or deduction may be passed through to the ESBT beneficiaries and capital losses are allowed only to the extent of capital gains.

Two Considerations

There are two particularly important considerations which should influence the planner in deciding whether a new business entity should be a pass-through entity (partnership or limited liability company) or an S corporation.

1. Generally a trust of any type can be an equity owner in a partnership or an LLC. As noted, only a QSST or an ESBT can be a shareholder in an S corporation. The limitation to one beneficiary of the QSST and the high income tax rates of the ESBT can be significant disadvantages.

2. In an S corporation which holds highly appreciated assets, when a shareholder dies that stock receives a step-up in basis but the assets owned by the S corporation do not receive a step-up in basis. There is a step-up on the "outside"; there is no step-up in basis on the "inside."

   If the assets of the S corporation are sold after the shareholder's death, it is possible to capture the economic benefit of the "outside" step-up in basis by selling the corporate assets and liquidating the S Corporation in the same tax year.

Planning Aspects

This treatment is not universally available. In establishing a new entity, the planner should be sensitive to these estate planning aspects of S corporation status.

GIFTS

For a family with a large estate, gifts of interests in the closely held business can be a particularly effective estate planning technique. The $10,000 annual exclusion can provide a tax-free method to transfer interests to family members. The senior generation may gradually shift ownership by a series of annual exclusion gifts, reducing the estates of the senior generation and eventually reducing the estate tax.

Because most family businesses do not pay significant dividends, these gifts may not provide a "spendable inheritance" to the children and such gifts may not diminish the "spendable resources" of the parent(s) (who may continue to draw substantial compensation and associated benefits).

Four Planning Steps

The same planning steps discussed generally in Chapters 3 and 4 apply to gifts of interests in a closely held business.

Large Gift-Shift Appreciation

If the parents make a large gift using the unified credit, the gift will shift the value of the donated property as well as future income and future appreciation.

Discount

As previously noted, a central part of contemporary estate planning is to **discount** the value of a minority, noncontrolling interest in a business entity. For a family with Big Board portfolio assets, the incentive to create a family discount partnership or other entity exists. To some extent, such planning is an artifice designed to "manufacture a discount" where none previously existed.

For the owner of the closely held business, however, there is usually a business entity in place which already presents the opportunity for gifts of minority interests in the closely held business which already "qualified" for a **discount** for federal gift tax purposes. In effect, the owner of the closely held business has already done the "discount planning" which is so popular.

GENERATION-SKIPPING CONSIDERATIONS

As with other assets, in going forward with gifts and particularly large unified credit gifts, it is essential to examine whether gifts to trusts may promote intergenerational tax savings. The $1 million GST exemption can also be a powerful tool in the context of gifts in the closely held business.

Basis Considerations

It has previously been noted that an asset transferred by gift has a **carry-over basis** in the hands of the donee whereas an asset transferred by testamentary request has a stepped-up basis in the hands of the transferee. These considerations — basis and the associated income tax consequences — often shape which assets are used for a gift program.

If the anticipation is that the closely held business will stay in the family at least through the second generation, the carryover basis which attaches to gifts may not be a significant disadvantage (since there will not be a sale of the assets which would otherwise trigger income tax). From a basis perspective, there may be flexibility in making gifts which does not attach to other appreciated assets.

CHAPTER 8

PRACTICAL CONSIDERATIONS

CHECKLISTS

INTRODUCTORY CHECKLIST

It may be useful to develop an introductory checklist for clients to complete. This checklist would provide background information for estate planning. In addition to name, address, family information, and financial information, the checklist may include the following questions:

1. Are your wills (or wills and revocable trusts) up-to-date?

2. What is your net worth, including life insurance?

   a. For a couple with a net worth substantially in excess of the applicable credit amount ($650,000 in 1999 and increasing to $1 million in 2006), it would be advisable to do planning to establish a Credit Shelter Trust from the first estate (or otherwise making sure that a couple eventually takes advantage of both unified credits).

   b. Is your net worth substantially in excess of $2 million, including a substantial life insurance policy? (This suggests not only the advisability of planning using a Credit Shelter Trust, but also the use of an irrevocable life insurance trust to hold the life insurance policy.)

   c. Is your net worth sufficiently large (perhaps $4 million for a 50-year-old couple or $3 million for a 70-year-old couple) to suggest the advantages of a program of $10,000 annual exclusion gifts for children and grandchildren?

3. For clients with a very large estate, does it seem advisable to consider any of the following?

   a. A program of $10,000 annual exclusion gifts.

   b. A larger gift, using the applicable credit amount, to shift future appreciation to the second generation and to the third generation.

c. Structuring gifts in generation-skipping trusts for the children (not only to shift future appreciation to the second generation, but also to the third generation, by means of the generation-skipping technique).

d. A QPRT (Qualified Personal Residence Trust) to own either the principal residence or the vacation residence. (This would make it possible to transfer the residence at a substantially **discounted value** for federal gift tax purposes.)

e. The formation of a Family Discount Partnership (or other entity) to make possible gifts with a **discounted value** for federal gift tax purposes and possibly to discount the value of the estate for federal estate tax purposes.

4. Do you have any low-basis assets, primed for sale, which you have been holding in order to avoid capital gains taxation upon sale? Would it be appropriate to consider the establishment of a CRT (Charitable Remainder Trust)? (This technique would make it possible to sell the appreciated property with no capital gains taxation, reserving an annual annuity for life.)

5. With respect to any qualified retirement plan, IRA, 401(k) plan or other pension plan:

   a. Is the first beneficiary the surviving spouse? This is in order to qualify for a spousal rollover — deferring the income tax on the disposition).

   b. If spouse is not surviving (or for a single person), should the beneficiary be the children **outright** or should the beneficiary designation (if spouse is not surviving) be the "estate of the participant" or such other beneficiary designation which will assure that the funds are held in trust for children who have not reached an age of maturity?. [This is often a very important consideration, particularly because many clients have a substantial portion of the net worth embodied in a qualified retirement plan, an IRA or a 401(k) plan.]

6. With respect to life insurance on the client's life which the client owns in the client's own name:

   a. If the spouse is surviving, is the beneficiary designation such that the proceeds would be available to fill the Credit Shelter Trust? (It is often the case that a couple has embodied Credit Shelter Trust planning in their wills, but the beneficiary designation on life insurance is outright to the surviving spouse. It is preferable that the proceeds be payable to the estate of the insured, or to the revocable trust, so that the proceeds will be available to help fill the Credit Shelter Trust.)

7. If the surviving parent were to die, is the disposition of property under the wills **outright** to the children or in **trust**? Should a generation-skipping trust be established (in the will) to hold the eventual inheritance of a child (which trust would make the income and principal available to the child but would continue — unless expended — for the lifetime of the child).

This may be advisable for at least three reasons:

- To protect the property from federal transfer tax when the property eventually passes to the grandchildren.

- To protect the property if the child is sued.

- To protect the property if the child is divorced. (This is often very attractive planning for clients who have a concern about the marriage of one or more of the children.)

8. Do you or your spouse anticipate a substantial inheritance? If so, would it be advisable for your parents to provide that your inheritance would pass in a lifetime generation-skipping trust? [Note that the client (or spouse) can maintain full control as trustee of that trust, but the property, in trust, will have the protections noted above.]

9. What is the respective title to property? Most in husband's name? Most in wife's name? Most in joint tenancy with right of survivorship? (Particularly for couples who embody Credit Shelter Trust planning in their wills, the goal is that the husband and wife each have a significant estate in their own name. Ideally, the husband and wife would each have $1 million in their own name by 2006. For couples with Credit Shelter Trust planning, it is generally advisable to avoid ownership of property as joint tenants with right of survivorship, (except for small checking accounts, vehicles, and the like.)

10. Do you have updated financial durable powers of attorney, medical durable powers of attorney and living wills? (Generally by a financial durable power of attorney, one spouse grants to the other spouse, or a child, the authority to make financial decisions in the event of incapacity, without court involvement. Note that for a wealthy couple, the financial power of attorney should expressly include the authority to make gifts, since the IRS generally disallows gifts made under a durable financial power of attorney unless the durable financial power of attorney expressly includes the authority to make gifts.)

11. Are there special family circumstances which should be considered in updating of the estate plan? (For example, are there children from a prior marriage? Should there be set aside a part or all of the applicable credit amount to the children from the first marriage as part of the estate plan? Would it be appropriate to consider life insurance, to be held in an irrevocable life insurance trust, to make sure that the children of the first marriage receive a significant inheritance, and do not have to wait for the estate of the second spouse in order to receive an inheritance?)

12. Are there special business circumstances which should be considered in the estate plan (such as issues of continuity of control, the use of the $1,300,000 business exclusion, or gifts of interests in the family business).

ANNUAL CHECKLIST

1. Have you acquired any significant new property this year? Is the title to property consistent with the estate planning goals? (See Introductory Checklist Question 9, above.)

2. Have you established a Qualified Retirement Plan, IRA, or 401(k) plan this year? Is beneficiary designation consistent with your estate planning goals? (See Introductory Checklist Question 5, above.)

3. Have you acquired any new life insurance this year? Is the beneficiary designation consistent with the estate planning goals? (See Introductory Checklist Question 6, above.)

4. Did you make any gift this year to any person? (It may be necessary to file a federal gift tax return for purposes of reporting gift-splitting, or allocating the federal generation-skipping tax exemption, or commencing the statute of limitations, even if there was no gift in excess of $10,000.)

5. Was there any major personal event this year — marriage, divorce, inheritance, substantial increase in wealth, birth of a child, death of a family member, sale of a business — which suggests the need to update the basic estate plan?

6. Has there been some change in personal relationships, or retirement or death of a friend or a family member, so that there should be a change in the fiduciaries in the existing estate planning documents — guardian, personal representative (executor), trustee?

APPENDIX

TAX FORMS

Tax Form	Page
990-PF — Return of Private Foundation	157
990-T — Exempt Organization Business Income Tax Return	169
1023 — Application for Recognition of Exemption	173
SS-4 — Application for Employer Identification Number	199
8718 — User Fee for Exempt Organization	201

Form **990-PF**

Department of the Treasury
Internal Revenue Service

Return of Private Foundation
or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation

Note: *The organization may be able to use a copy of this return to satisfy state reporting requirements.*

OMB No. 1545-0052

1999

For calendar year 1999, or tax year beginning , 1999, and ending

Use the IRS label. Otherwise, please print or type. See Specific Instructions.	Name of organization		A Employer identification number
	Number and street (or P.O. box number if mail is not delivered to street address)	Room/suite	B Telephone number (see page 9 of the instructions) ( )
	City or town, state, and ZIP + 4		C If exemption application is pending, check here ▶ ☐

D 1. Foreign organizations, check here . . ▶ ☐
2. Organizations meeting the 85% test, check here and attach computation . . ▶ ☐

H Check type of organization: ☐ Section 501(c)(3) exempt private foundation
☐ Section 4947(a)(1) nonexempt charitable trust ☐ Other taxable private foundation

E If private foundation status was terminated under section 507(b)(1)(A), check here . . ▶ ☐

I Fair market value of all assets at end of year *(from Part II, col. (c), line 16)* ▶ $

J Accounting method: ☐ Cash ☐ Accrual
☐ Other (specify) ....
(Part I, column (d) must be on cash basis.)

F If the foundation is in a 60-month termination under section 507(b)(1)(B), check here . . ▶ ☐

G If address changed, check here . . . ▶ ☐

Part I **Analysis of Revenue and Expenses** *(The total of amounts in columns (b), (c), and (d) may not necessarily equal the amounts in column (a) (see page 9 of the instructions).)*

		(a) Revenue and expenses per books	(b) Net investment income	(c) Adjusted net income	(d) Disbursements for charitable purposes (cash basis only)
Revenue	1 Contributions, gifts, grants, etc., received (attach schedule)				
	2 Contributions from split-interest trusts				
	3 Interest on savings and temporary cash investments				
	4 Dividends and interest from securities				
	5a Gross rents				
	b (Net rental income or (loss) ______________)				
	6 Net gain or (loss) from sale of assets not on line 10				
	7 Capital gain net income (from Part IV, line 2) . .				
	8 Net short-term capital gain				
	9 Income modifications				
	10a Gross sales less returns and allowances				
	b Less: Cost of goods sold . .				
	c Gross profit or (loss) (attach schedule)				
	11 Other income (attach schedule)				
	12 **Total.** Add lines 1 through 11				
Operating and Administrative Expenses	13 Compensation of officers, directors, trustees, etc.				
	14 Other employee salaries and wages				
	15 Pension plans, employee benefits				
	16a Legal fees (attach schedule)				
	b Accounting fees (attach schedule)				
	c Other professional fees (attach schedule) . . .				
	17 Interest				
	18 Taxes (attach schedule) (see page 12 of the instructions)				
	19 Depreciation (attach schedule) and depletion .				
	20 Occupancy				
	21 Travel, conferences, and meetings				
	22 Printing and publications				
	23 Other expenses (attach schedule)				
	24 **Total operating and administrative expenses.** Add lines 13 through 23				
	25 Contributions, gifts, grants paid				
	26 **Total expenses and disbursements.** Add lines 24 and 25				
	27 **Subtract line 26 from line 12:**				
	a **Excess of revenue over expenses and disbursements**				
	b **Net investment income** (if negative, enter -0-) .				
	c **Adjusted net income** (if negative, enter -0-) . .				

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Part II Balance Sheets Attached schedules and amounts in the description column should be for end-of-year amounts only. (See instructions.)

		Beginning of year	End of year	
		(a) Book Value	(b) Book Value	(c) Fair Market Value
Assets	1 Cash—non-interest-bearing			
	2 Savings and temporary cash investments			
	3 Accounts receivable ▶			
	Less: allowance for doubtful accounts ▶			
	4 Pledges receivable ▶			
	Less: allowance for doubtful accounts ▶			
	5 Grants receivable			
	6 Receivables due from officers, directors, trustees, and other disqualified persons (attach schedule) (see page 14 of the instructions)			
	7 Other notes and loans receivable (attach schedule) ▶			
	Less: allowance for doubtful accounts ▶			
	8 Inventories for sale or use			
	9 Prepaid expenses and deferred charges			
	10a Investments—U.S. and state government obligations (attach schedule)			
	b Investments—corporate stock (attach schedule)			
	c Investments—corporate bonds (attach schedule)			
	11 Investments—land, buildings, and equipment: basis ▶			
	Less: accumulated depreciation (attach schedule) ▶			
	12 Investments—mortgage loans			
	13 Investments—other (attach schedule)			
	14 Land, buildings, and equipment: basis ▶			
	Less: accumulated depreciation (attach schedule) ▶			
	15 Other assets (describe ▶)			
	16 **Total assets** (to be completed by all filers—see page 15 of the instructions. Also, see page 1, item I)			
Liabilities	17 Accounts payable and accrued expenses			
	18 Grants payable			
	19 Deferred revenue			
	20 Loans from officers, directors, trustees, and other disqualified persons			
	21 Mortgages and other notes payable (attach schedule)			
	22 Other liabilities (describe ▶)			
	23 **Total liabilities** (add lines 17 through 22)			
Net Assets or Fund Balances	**Organizations that follow SFAS 117, check here ▶ ☐ and complete lines 24 through 26 and lines 30 and 31.**			
	24 Unrestricted			
	25 Temporarily restricted			
	26 Permanently restricted			
	Organizations that do not follow SFAS 117, check here ▶ ☐ and complete lines 27 through 31.			
	27 Capital stock, trust principal, or current funds			
	28 Paid-in or capital surplus, or land, bldg., and equipment fund			
	29 Retained earnings, accumulated income, endowment, or other funds			
	30 **Total net assets or fund balances** (see page 16 of the instructions)			
	31 **Total liabilities and net assets/fund balances** (see page 16 of the instructions)			

Part III Analysis of Changes in Net Assets or Fund Balances

1 Total net assets or fund balances at beginning of year—Part II, column (a), line 30 (must agree with end-of-year figure reported on prior year's return)	1	
2 Enter amount from Part I, line 27a	2	
3 Other increases not included in line 2 (itemize) ▶	3	
4 Add lines 1, 2, and 3	4	
5 Decreases not included in line 2 (itemize) ▶	5	
6 Total net assets or fund balances at end of year (line 4 minus line 5)—Part II, column (b), line 30	6	

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Part IV Capital Gains and Losses for Tax on Investment Income

	(a) List and describe the kind(s) of property sold (e.g., real estate, 2-story brick warehouse; or common stock, 200 shs. MLC Co.)	(b) How acquired P—Purchase D—Donation	(c) Date acquired (mo., day, yr.)	(d) Date sold (mo., day, yr.)
1a				
b				
c				
d				
e				

	(e) Gross sales price	(f) Depreciation allowed (or allowable)	(g) Cost or other basis plus expense of sale	(h) Gain or (loss) (e) plus (f) minus (g)
a				
b				
c				
d				
e				

	Complete only for assets showing gain in column (h) and owned by the foundation on 12/31/69			(l) Gains (Col. (h) gain minus col. (k), but not less than -0-) **or** Losses (from col.(h))
	(i) F.M.V. as of 12/31/69	(j) Adjusted basis as of 12/31/69	(k) Excess of col. (i) over col. (j), if any	
a				
b				
c				
d				
e				

2 Capital gain net income or (net capital loss). { If gain, also enter in Part I, line 7; If (loss), enter -0- in Part I, line 7 } . . . **2**

3 Net short-term capital gain or (loss) as defined in sections 1222(5) and (6):
If gain, also enter in Part I, line 8, column (c) (see pages 11 and 16 of the instructions).
If (loss), enter -0- in Part I, line 8 . . . . **3**

Part V Qualification Under Section 4940(e) for Reduced Tax on Net Investment Income

(For optional use by domestic private foundations subject to the section 4940(a) tax on net investment income.)

If section 4940(d)(2) applies, leave this part blank.

Was the organization liable for the section 4942 tax on the distributable amount of any year in the base period? ☐ Yes ☐ No
If "Yes," the organization does not qualify under section 4940(e). Do not complete this part.

1 Enter the appropriate amount in each column for each year; see page 16 of the instructions before making any entries.

(a) Base period years Calendar year (or tax year beginning in)	(b) Adjusted qualifying distributions	(c) Net value of noncharitable-use assets	(d) Distribution ratio (col. (b) divided by col. (c))
1998			
1997			
1996			
1995			
1994			

2 **Total** of line 1, column (d) **2**

3 Average distribution ratio for the 5-year base period—divide the total on line 2 by 5, or by the number of years the foundation has been in existence if less than 5 years **3**

4 Enter the net value of noncharitable-use assets for 1999 from Part X, line 5 . . . . . . **4**

5 Multiply line 4 by line 3 . . . . **5**

6 Enter 1% of net investment income (1% of Part I, line 27b) **6**

7 Add lines 5 and 6 . . . . **7**

8 Enter qualifying distributions from Part XII, line 4 . . . . **8**
If line 8 is equal to or greater than line 7, check the box in Part VI, line 1b, and complete that part using a 1% tax rate. See the Part VI instructions on page 16.

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Part VI Excise Tax Based on Investment Income (Section 4940(a), 4940(b), 4940(e), or 4948—see page 16 of the instructions)

1a	Exempt operating foundations described in section 4940(d)(2), check here ▶ ☐ and enter "N/A" on line 1. Date of ruling letter: .... **(attach copy of ruling letter if necessary–see instructions)**		
b	Domestic organizations that meet the section 4940(e) requirements in Part V, check here ▶ ☐ and enter 1% of Part I, line 27b	1	
c	All other domestic organizations enter 2% of line 27b. Exempt foreign organizations enter 4% of Part I, line 12, col. (b)		
2	Tax under section 511 (domestic section 4947(a)(1) trusts and taxable foundations only. Others enter -0-)	2	
3	Add lines 1 and 2	3	
4	Subtitle A (income) tax (domestic section 4947(a)(1) trusts and taxable foundations only. Others enter -0-)	4	
5	**Tax based on investment income.** Subtract line 4 from line 3. If zero or less, enter -0-	5	
6	Credits/Payments:		
a	1999 estimated tax payments and 1998 overpayment credited to 1999 — 6a		
b	Exempt foreign organizations—tax withheld at source — 6b		
c	Tax paid with application for extension of time to file (Form 2758) — 6c		
d	Backup withholding erroneously withheld — 6d		
7	Total credits and payments. Add lines 6a through 6d	7	
8	Enter any **PENALTY** for underpayment of estimated tax. Check here ☐ if Form 2220 is attached	8	
9	**TAX DUE.** If the total of lines 5 and 8 is more than line 7, enter **AMOUNT OWED** ▶	9	
10	**OVERPAYMENT.** If line 7 is more than the total of lines 5 and 8, enter the **AMOUNT OVERPAID** ▶	10	
11	Enter the amount of line 10 to be: **Credited to 2000 estimated tax ▶** **Refunded ▶**	11	

Part VII-A Statements Regarding Activities

			Yes	No
1a	During the tax year, did the organization attempt to influence any national, state, or local legislation or did it participate or intervene in any political campaign?	1a		
b	Did it spend more than $100 during the year (either directly or indirectly) for political purposes (see page 17 of the instructions for definition)?	1b		
	*If the answer is "Yes" to **1a** or **1b**, attach a detailed description of the activities and copies of any materials published or distributed by the organization in connection with the activities.*			
c	Did the organization file **Form 1120-POL** for this year?	1c		
d	Enter the amount (if any) of tax on political expenditures (section 4955) imposed during the year: **(1)** On the organization. ▶ $ ______ **(2)** On organization managers. ▶ $ ______			
e	Enter the reimbursement (if any) paid by the organization during the year for political expenditure tax imposed on organization managers. ▶ $ ______			
2	Has the organization engaged in any activities that have not previously been reported to the IRS? *If "Yes," attach a detailed description of the activities.*	2		
3	Has the organization made any changes, not previously reported to the IRS, in its governing instrument, articles of incorporation, or bylaws, or other similar instruments? *If "Yes," attach a conformed copy of the changes*	3		
4a	Did the organization have unrelated business gross income of $1,000 or more during the year?	4a		
b	If "Yes," has it filed a tax return on **Form 990-T** for this year?	4b		
5	Was there a liquidation, termination, dissolution, or substantial contraction during the year? *If "Yes," attach the statement required by General Instruction T.*	5		
6	Are the requirements of section 508(e) (relating to sections 4941 through 4945) satisfied either: • By language in the governing instrument; or • By state legislation that effectively amends the governing instrument so that no mandatory directions that conflict with the state law remain in the governing instrument?	6		
7	Did the organization have at least $5,000 in assets at any time during the year? *If "Yes," complete Part II, col. (c), and Part XV.*	7		
8a	Enter the states to which the foundation reports or with which it is registered (see page 18 of the instructions) ▶			
b	If the answer is "Yes" to line 7, has the organization furnished a copy of Form 990-PF to the Attorney General (or designate) of each state as required by General Instruction G? *If "No," attach explanation*	8b		
9	Is the organization claiming status as a private operating foundation within the meaning of section 4942(j)(3) or 4942(j)(5) for calendar year 1999 or the taxable year beginning in 1999 (see instructions for Part XIV on page 23)? *If "Yes," complete Part XIV*	9		
10	Did any persons become substantial contributors during the tax year? *If "Yes," attach a schedule listing their names and addresses.*	10		
11a	Did anyone request to see either the organization's annual return or its exemption application (or both)?	11a		
b	If "Yes," did the organization comply pursuant to the instructions? (See General Instruction Q.)	11b		

12 The books are in care of ▶ .... Telephone no. ▶ ....
Located at ▶ .... ZIP+4 ▶ ....

13 Section 4947(a)(1) nonexempt charitable trusts filing Form 990-PF in lieu of **Form 1041**—Check here ▶ ☐
and enter the amount of tax-exempt interest received or accrued during the year ▶ | 13 |

Form **990-PF** (1999)

Part VII-B Statements Regarding Activities for Which Form 4720 May Be Required

File Form 4720 if any item is checked in the "Yes" column, unless an exception applies. | Yes | No

1 Self-dealing (section 4941):

a During the year did the organization (either directly or indirectly):

(1) Engage in the sale or exchange, or leasing of property with a disqualified person? ☐ Yes ☐ No

(2) Borrow money from, lend money to, or otherwise extend credit to (or accept it from) a disqualified person? ☐ Yes ☐ No

(3) Furnish goods, services, or facilities to (or accept them from) a disqualified person? ☐ Yes ☐ No

(4) Pay compensation to, or pay or reimburse the expenses of, a disqualified person? ☐ Yes ☐ No

(5) Transfer any income or assets to a disqualified person (or make any of either available for the benefit or use of a disqualified person)? ☐ Yes ☐ No

(6) Agree to pay money or property to a government official? (**Exception.** Check "No" if the organization agreed to make a grant to or to employ the official for a period after termination of government service, if terminating within 90 days.) ☐ Yes ☐ No

b If any answer is "Yes" to 1a(1)–(6), did ANY of the acts fail to qualify under the exceptions described in Regulations section 53.4941(d)-3 or in a current notice regarding disaster assistance (see page 18 of the instructions)? **1b**

Organizations relying on a current notice regarding disaster assistance check here ▶ ☐

c Did the organization engage in a prior year in any of the acts described in 1a, other than excepted acts, that were not corrected before the first day of the tax year beginning in 1999? **1c**

2 Taxes on failure to distribute income (section 4942) (does not apply for years the organization was a private operating foundation defined in section 4942(j)(3) or 4942(j)(5)):

a At the end of tax year 1999, did the organization have any undistributed income (lines 6d and 6e, Part XIII) for tax year(s) beginning before 1999? ☐ Yes ☐ No

If "Yes," list the years ▶ 19.... , 19.... , 19.... , 19.....

b Are there any years listed in 2a for which the organization is **NOT** applying the provisions of section 4942(a)(2) (relating to incorrect valuation of assets) to the year's undistributed income? (If applying section 4942(a)(2) to ALL years listed, answer "No" and attach statement—see page 18 of the instructions.) **2b**

c If the provisions of section 4942(a)(2) are being applied to ANY of the years listed in 2a, list the years here.

▶ 19.... , 19.... , 19.... , 19.....

3 Taxes on excess business holdings (section 4943):

a Did the organization hold more than a 2% direct or indirect interest in any business enterprise at any time during the year? ☐ Yes ☐ No

b If "Yes," did it have excess business holdings in 1999 as a result of **(1)** any purchase by the organization or disqualified persons after May 26, 1969; **(2)** the lapse of the 5-year period (or longer period approved by the Commissioner under section 4943(c)(7)) to dispose of holdings acquired by gift or bequest; or **(3)** the lapse of the 10-, 15-, or 20-year first phase holding period? *(Use Schedule C, Form 4720, to determine if the organization had excess business holdings in 1999.)* **3b**

4 Taxes on investments that jeopardize charitable purposes (section 4944):

a Did the organization invest during the year any amount in a manner that would jeopardize its charitable purposes? **4a**

b Did the organization make any investment in a prior year (but after December 31, 1969) that could jeopardize its charitable purpose that had not been removed from jeopardy before the first day of the tax year beginning in 1999? **4b**

5 Taxes on taxable expenditures (section 4945) and political expenditures (section 4955):

a During the year did the organization pay or incur any amount to:

(1) Carry on propaganda, or otherwise attempt to influence legislation (section 4945(e))? ☐ Yes ☐ No

(2) Influence the outcome of any specific public election (see section 4955); or to carry on, directly or indirectly, any voter registration drive? ☐ Yes ☐ No

(3) Provide a grant to an individual for travel, study, or other similar purposes? ☐ Yes ☐ No

(4) Provide a grant to an organization other than a charitable, etc., organization described in section 509(a)(1), (2), or (3), or section 4940(d)(2)? ☐ Yes ☐ No

(5) Provide for any purpose other than religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals? ☐ Yes ☐ No

b If any answer is "Yes" to 5a(1)–(5), did ANY of the transactions fail to qualify under the exceptions described in Regulations section 53.4945 or in a current notice regarding disaster assistance (see page 19 of the instructions)? **5b**

Organizations relying on a current notice regarding disaster assistance check here ▶ ☐

c If the answer is "Yes" to question 5a(4), does the organization claim exemption from the tax because it maintained expenditure responsibility for the grant? ☐ Yes ☐ No

If "Yes," attach the statement required by Regulations section 53.4945-5(d).

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Part VIII **Information About Officers, Directors, Trustees, Foundation Managers, Highly Paid Employees, and Contractors**

1 List all officers, directors, trustees, foundation managers and their compensation (see page 19 of the instructions):

(a) Name and address	(b) Title, and average hours per week devoted to position	(c) Compensation (If not paid, enter -0-)	(d) Contributions to employee benefit plans and deferred compensation	(e) Expense account, other allowances

2 Compensation of five highest-paid employees (other than those included on line 1—see page 19 of the instructions). If none, enter "NONE."

(a) Name and address of each employee paid more than $50,000	(b) Title and average hours per week devoted to position	(c) Compensation	(d) Contributions to employee benefit plans and deferred compensation	(e) Expense account, other allowances

Total number of other employees paid over $50,000 . . . . ▶

3 Five highest-paid independent contractors for professional services—(see page 19 of the instructions). If none, enter "NONE."

(a) Name and address of each person paid more than $50,000	(b) Type of service	(c) Compensation

Total number of others receiving over $50,000 for professional services . . . . ▶

Part IX-A **Summary of Direct Charitable Activities**

List the foundation's four largest direct charitable activities during the tax year. Include relevant statistical information such as the number of organizations and other beneficiaries served, conferences convened, research papers produced, etc.	Expenses
1	
2	
3	
4	

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Part IX-B Summary of Program-Related Investments (see page 20 of the instructions)

Describe any program-related investments made by the foundation during the tax year	Amount
1	
2	
3	

Part X Minimum Investment Return (All domestic foundations must complete this part. Foreign foundations, see page 20 of the instructions.)

1	Fair market value of assets not used (or held for use) directly in carrying out charitable, etc., purposes:		
a	Average monthly fair market value of securities	1a	
b	Average of monthly cash balances	1b	
c	Fair market value of all other assets (see page 21 of the instructions)	1c	
d	**Total** (add lines 1a, b, and c)	1d	
e	Reduction claimed for blockage or other factors reported on lines 1a and 1c (attach detailed explanation) — 1e		
2	Acquisition indebtedness applicable to line 1 assets	2	
3	Subtract line 2 from line 1d	3	
4	Cash deemed held for charitable activities. Enter 1½% of line 3 (for greater amount, see page 21 of the instructions)	4	
5	**Net value of noncharitable-use assets.** Subtract line 4 from line 3. Enter here and on Part V, line 4	5	
6	**Minimum investment return.** Enter 5% of line 5	6	

Part XI Distributable Amount (see page 21 of the instructions) (Section 4942(j)(3) and (j)(5) private operating foundations and certain foreign organizations check here ▶ ☐ and do not complete this part.)

1	Minimum investment return from Part X, line 6	1	
2a	Tax on investment income for 1999 from Part VI, line 5 — 2a		
b	Income tax for 1999. (This does not include the tax from Part VI.) — 2b		
c	Add lines 2a and 2b	2c	
3	Distributable amount before adjustments. Subtract line 2c from line 1	3	
4a	Recoveries of amounts treated as qualifying distributions — 4a		
b	Income distributions from section 4947(a)(2) trusts — 4b		
c	Add lines 4a and 4b	4c	
5	Add lines 3 and 4c	5	
6	Deduction from distributable amount (see page 22 of the instructions)	6	
7	**Distributable amount** as adjusted. Subtract line 6 from line 5. Enter here and on Part XIII, line 1	7	

Part XII Qualifying Distributions (see page 22 of the instructions)

1	Amounts paid (including administrative expenses) to accomplish charitable, etc., purposes:		
a	Expenses, contributions, gifts, etc.—total from Part I, column (d), line 26	1a	
b	Program-related investments—total of lines 1-3 of Part IX-B	1b	
2	Amounts paid to acquire assets used (or held for use) directly in carrying out charitable, etc., purposes	2	
3	Amounts set aside for specific charitable projects that satisfy the:		
a	Suitability test (prior IRS approval required)	3a	
b	Cash distribution test (attach the required schedule)	3b	
4	**Qualifying distributions.** Add lines 1a through 3b. Enter here and on Part V, line 8, and Part XIII, line 4	4	
5	Organizations that qualify under section 4940(e) for the reduced rate of tax on net investment income. Enter 1% of Part I, line 27b (see page 22 of the instructions)	5	
6	**Adjusted qualifying distributions.** Subtract line 5 from line 4	6	

Note: *The amount on line 6 will be used in Part V, column (b), in subsequent years when calculating whether the foundation qualifies for the section 4940(e) reduction of tax in those years.*

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Part XIII **Undistributed Income** (see page 22 of the instructions)

		(a) Corpus	(b) Years prior to 1998	(c) 1998	(d) 1999
1	Distributable amount for 1999 from Part XI, line 7				
2	Undistributed income, if any, as of the end of 1998:				
a	Enter amount for 1998 only				
b	Total for prior years: 19____,19____,19____				
3	Excess distributions carryover, if any, to 1999:				
a	From 1994				
b	From 1995				
c	From 1996				
d	From 1997				
e	From 1998				
f	**Total** of lines 3a through e				
4	Qualifying distributions for 1999 from Part XII, line 4: ▶ $ ______				
a	Applied to 1998, but not more than line 2a				
b	Applied to undistributed income of prior years (Election required—see page 23 of the instructions)				
c	Treated as distributions out of corpus (Election required—see page 23 of the instructions)				
d	Applied to 1999 distributable amount				
e	Remaining amount distributed out of corpus				
5	Excess distributions carryover applied to 1999 *(If an amount appears in column (d), the same amount must be shown in column (a).)*				
6	**Enter the net total of each column as indicated below:**				
a	Corpus. Add lines 3f, 4c, and 4e. Subtract line 5				
b	Prior years' undistributed income. Subtract line 4b from line 2b				
c	Enter the amount of prior years' undistributed income for which a notice of deficiency has been issued, or on which the section 4942(a) tax has been previously assessed				
d	Subtract line 6c from line 6b. Taxable amount—see page 23 of the instructions				
e	Undistributed income for 1998. Subtract line 4a from line 2a. Taxable amount—see page 23 of the instructions				
f	Undistributed income for 1999. Subtract lines 4d and 5 from line 1. This amount must be distributed in 2000				
7	Amounts treated as distributions out of corpus to satisfy requirements imposed by section 170(b)(1)(E) or 4942(g)(3) (see page 23 of the instructions)				
8	Excess distributions carryover from 1994 not applied on line 5 or line 7 (see page 23 of the instructions)				
9	**Excess distributions carryover to 2000.** Subtract lines 7 and 8 from line 6a				
10	Analysis of line 9:				
a	Excess from 1995				
b	Excess from 1996				
c	Excess from 1997				
d	Excess from 1998				
e	Excess from 1999				

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Part XIV **Private Operating Foundations** (see page 24 of the instructions and Part VII-A, question 9)

1a If the foundation has received a ruling or determination letter that it is a private operating foundation, and the ruling is effective for 1999, enter the date of the ruling . . . . . ▶

b Check box to indicate whether the organization is a private operating foundation described in section ☐ 4942(j)(3) or ☐ 4942(j)(5)

	Tax year	Prior 3 years			
	(a) 1999	**(b)** 1998	**(c)** 1997	**(d)** 1996	**(e) Total**
2a Enter the lesser of the adjusted net income from Part I or the minimum investment return from Part X for each year listed					
b 85% of line 2a					
c Qualifying distributions from Part XII, line 4 for each year listed					
d Amounts included in line 2c not used directly for active conduct of exempt activities					
e Qualifying distributions made directly for active conduct of exempt activities. Subtract line 2d from line 2c					
3 Complete 3a, b, or c for the alternative test relied upon:					
a "Assets" alternative test—enter: **(1)** Value of all assets					
(2) Value of assets qualifying under section 4942(j)(3)(B)(i)					
b "Endowment" alternative test— Enter ⅔ of minimum investment return shown in Part X, line 6 for each year listed					
c "Support" alternative test—enter: **(1)** Total support other than gross investment income (interest, dividends, rents, payments on securities loans (section 512(a)(5)), or royalties)					
(2) Support from general public and 5 or more exempt organizations as provided in section 4942(j)(3)(B)(iii)					
(3) Largest amount of support from an exempt organization					
(4) Gross investment income					

Part XV **Supplementary Information (Complete this part only if the organization had $5,000 or more in assets at any time during the year—see page 24 of the instructions.)**

1 **Information Regarding Foundation Managers:**

a List any managers of the foundation who have contributed more than 2% of the total contributions received by the foundation before the close of any tax year (but only if they have contributed more than $5,000). (See section 507(d)(2).)

b List any managers of the foundation who own 10% or more of the stock of a corporation (or an equally large portion of the ownership of a partnership or other entity) of which the foundation has a 10% or greater interest.

2 **Information Regarding Contribution, Grant, Gift, Loan, Scholarship, etc., Programs:**

Check here ▶ ☐ if the organization only makes contributions to preselected charitable organizations and does not accept unsolicited requests for funds. If the organization makes gifts, grants, etc. (see page 24 of the instructions) to individuals or organizations under other conditions, complete items 2a, b, c, and d.

a The name, address, and telephone number of the person to whom applications should be addressed:

b The form in which applications should be submitted and information and materials they should include:

c Any submission deadlines:

d Any restrictions or limitations on awards, such as by geographical areas, charitable fields, kinds of institutions, or other factors:

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Part XV Supplementary Information (continued)

3 Grants and Contributions Paid During the Year or Approved for Future Payment

Recipient Name and address (home or business)	If recipient is an individual, show any relationship to any foundation manager or substantial contributor	Foundation status of recipient	Purpose of grant or contribution	Amount
a *Paid during the year*				
Total . . . . ▶ **3a**				
b *Approved for future payment*				
Total . . . . ▶ **3b**				

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Part XVI-A Analysis of Income-Producing Activities

Enter gross amounts unless otherwise indicated.	Unrelated business income		Excluded by section 512, 513, or 514		(e) Related or exempt function income (See page 24 of the instructions.)
	(a) Business code	(b) Amount	(c) Exclusion code	(d) Amount	
1 Program service revenue:					
a					
b					
c					
d					
e					
f					
g Fees and contracts from government agencies					
2 Membership dues and assessments					
3 Interest on savings and temporary cash investments					
4 Dividends and interest from securities					
5 Net rental income or (loss) from real estate:					
a Debt-financed property					
b Not debt-financed property					
6 Net rental income or (loss) from personal property					
7 Other investment income					
8 Gain or (loss) from sales of assets other than inventory					
9 Net income or (loss) from special events					
10 Gross profit or (loss) from sales of inventory					
11 Other revenue: a					
b					
c					
d					
e					
12 Subtotal. Add columns (b), (d), and (e)					

13 Total. Add line 12, columns (b), (d), and (e) . . . . ▶ 13 ____________

(See worksheet in line 13 instructions on page 25 to verify calculations.)

Part XVI-B Relationship of Activities to the Accomplishment of Exempt Purposes

Line No. ▼	Explain below how each activity for which income is reported in column (e) of Part XVI-A contributed importantly to the accomplishment of the organization's exempt purposes (other than by providing funds for such purposes). (See page 25 of the instructions.)

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Part XVII Information Regarding Transfers To and Transactions and Relationships With Noncharitable Exempt Organizations

		Yes	No
1 Did the organization directly or indirectly engage in any of the following with any other organization described in section 501(c) of the Code (other than section 501(c)(3) organizations) or in section 527, relating to political organizations?			
a Transfers from the reporting organization to a noncharitable exempt organization of:			
(1) Cash	1a(1)		
(2) Other assets	1a(2)		
b Other Transactions:			
(1) Sales of assets to a noncharitable exempt organization	1b(1)		
(2) Purchases of assets from a noncharitable exempt organization	1b(2)		
(3) Rental of facilities, equipment, or other assets	1b(3)		
(4) Reimbursement arrangements	1b(4)		
(5) Loans or loan guarantees	1b(5)		
(6) Performance of services or membership or fundraising solicitations	1b(6)		
c Sharing of facilities, equipment, mailing lists, other assets, or paid employees	1c		

d If the answer to any of the above is "Yes," complete the following schedule. Column **(b)** should always show the fair market value of the goods, other assets, or services given by the reporting organization. If the organization received less than fair market value in any transaction or sharing arrangement, show in column **(d)** the value of the goods, other assets, or services received.

(a) Line no.	(b) Amount involved	(c) Name of noncharitable exempt organization	(d) Description of transfers, transactions, and sharing arrangements

2a Is the organization directly or indirectly affiliated with, or related to, one or more tax-exempt organizations described in section 501(c) of the Code (other than section 501(c)(3)) or in section 527? ☐ Yes ☐ No

b If "Yes," complete the following schedule.

(a) Name of organization	(b) Type of organization	(c) Description of relationship

Part XVIII Public Inspection (see page 26 of the instructions and General Instruction Q)

1 Enter the date the notice of availability of the annual return appeared in a newspaper ▶ ....

2 Enter the name of the newspaper ▶ ....

3 Check here ▶ ☐ to indicate that you have attached a copy of the newspaper notice required by the instructions on page 26. (If the notice is not attached, the return will be considered incomplete.)

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer or fiduciary) is based on all information of which preparer has any knowledge.

▶ Signature of officer or trustee | Date | ▶ Title

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ▶ ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed) and address ▶		EIN ▶	
		ZIP+4 ▶	

Form **990-PF** (1999)

Form **990-T**

Department of the Treasury
Internal Revenue Service

Exempt Organization Business Income Tax Return
(and proxy tax under section 6033(e))

For calendar year 1999 or other tax year beginning .... , and ending ....

▶ See separate instructions.

OMB No. 1545-0687

1999

A ☐ Check box if address changed

B Exempt under section
☐ 501( )( )
☐ 408(e) ☐ 220(e)
☐ 408A ☐ 530(a)
☐ 529(a)

C Book value of all assets at end of year

Please Print or Type

Name of organization

Number, street, and room or suite no. (If a P.O. box, see page 6 of instructions.)

City or town, state, and ZIP code

D Employer identification number (Employees' trust, see instructions for Block D on page 6.)

E NEW unrelated bus. activity codes (See instructions for Block E on page 6.)

F Group exemption number (see instructions for Block F on page 6) ▶

G Check organization type ▶ ☐ 501(c) corporation ☐ 501(c) trust ☐ 401(a) trust ☐ Other trust

H Describe the organization's primary unrelated business activity. ▶

I During the tax year, was the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? . . ▶ ☐ Yes ☐ No
If "Yes," enter the name and identifying number of the parent corporation. ▶

J The books are in care of ▶ Telephone number ▶ ( )

Part I Unrelated Trade or Business Income

		Line	(A) Income	(B) Expenses	(C) Net
1a	Gross receipts or sales				
b	Less returns and allowances c Balance ▶	1c			
2	Cost of goods sold (Schedule A, line 7)	2			
3	Gross profit (subtract line 2 from line 1c)	3			
4a	Capital gain net income (attach Schedule D)	4a			
b	Net gain (loss) (Form 4797, Part II, line 18) (attach Form 4797)	4b			
c	Capital loss deduction for trusts	4c			
5	Income (loss) from partnerships and S corporations (attach statement)	5			
6	Rent income (Schedule C)	6			
7	Unrelated debt-financed income (Schedule E)	7			
8	Interest, annuities, royalties, and rents from controlled organizations (see page 8 of instructions)	8			
9	Investment income of a section 501(c)(7), (9), or (17) organization (Schedule G)	9			
10	Exploited exempt activity income (Schedule I)	10			
11	Advertising income (Schedule J)	11			
12	Other income (see page 8 of the instructions—attach schedule)	12			
13	**TOTAL** (combine lines 3 through 12)	13			

Part II Deductions Not Taken Elsewhere (See page 9 of the instructions for limitations on deductions.) (Except for contributions, deductions must be directly connected with the unrelated business income.)

		Line	Amount
14	Compensation of officers, directors, and trustees (Schedule K)	14	
15	Salaries and wages	15	
16	Repairs and maintenance	16	
17	Bad debts	17	
18	Interest (attach schedule)	18	
19	Taxes and licenses	19	
20	Charitable contributions (see page 10 of the instructions for limitation rules)	20	
21	Depreciation (attach Form 4562) 21		
22	Less depreciation claimed on Schedule A and elsewhere on return 22a	22b	
23	Depletion	23	
24	Contributions to deferred compensation plans	24	
25	Employee benefit programs	25	
26	Excess exempt expenses (Schedule I)	26	
27	Excess readership costs (Schedule J)	27	
28	Other deductions (attach schedule)	28	
29	**Total deductions** (add lines 14 through 28)	29	
30	Unrelated business taxable income before net operating loss deduction (subtract line 29 from line 13)	30	
31	Net operating loss deduction	31	
32	Unrelated business taxable income before specific deduction (subtract line 31 from line 30)	32	
33	Specific deduction (Generally $1,000, but see line 33 instructions for exceptions)	33	
34	**Unrelated business taxable income** (subtract line 33 from line 32). If line 33 is greater than line 32, enter the smaller of zero or line 32	34	

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Part III Tax Computation

35 Organizations Taxable as Corporations (see instructions for tax computation on page 12). Controlled group members (sections 1561 and 1563)—check here ☐. **See instructions** and:

a Enter your share of the $50,000, $25,000, and $9,925,000 taxable income brackets (in that order):
(1) $ (2) $ (3) $

b Enter organization's share of: (1) additional 5% tax (not more than $11,750) $
(2) additional 3% tax (not more than $100,000) $

c Income tax on the amount on line 34 ▶ **35c**

36 Trusts Taxable at Trust Rates (see instructions for tax computation on page 12) Income tax on the amount on line 34 from: ☐ Tax rate schedule or ☐ Schedule D (Form 1041) ▶ **36**

37 Proxy tax (see page 12 of the instructions) ▶ **37**

38 Total (add line 37 to line 35c or 36, whichever applies) **38**

Part IV Tax and Payments

39a Foreign tax credit (corporations attach Form 1118; trusts attach Form 1116) **39a**
b Other credits. (see page 13 of the instructions) **39b**
c General business credit—Check if from:
☐ Form 3800 or ☐ Form (specify) ▶ **39c**
d Credit for prior year minimum tax (attach Form 8801 or 8827) **39d**
e **Total credits** (add lines 39a through 39d) **39e**

40 Subtract line 39e from line 38 **40**

41 Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611 **41**

42 Alternative minimum tax **42**

43 **Total tax** (add lines 40, 41, and 42) **43**

44 **Payments: a** 1998 overpayment credited to 1999 **44a**
b 1999 estimated tax payments **44b**
c Tax deposited with Form 7004 or Form 2758 **44c**
d Foreign organizations—Tax paid or withheld at source (see instructions) **44d**
e Backup withholding (see instructions) **44e**
f Other credits and payments (see instructions) **44f**

45 **Total payments** (add lines 44a through 44f) **45**

46 Estimated tax penalty (see page 3 of the instructions). Check ▶ ☐ if Form 2220 is attached **46**

47 **Tax due**—If line 45 is less than the total of lines 43 and 46, enter amount owed ▶ **47**

48 **Overpayment**—If line 45 is larger than the total of lines 43 and 46, enter amount overpaid ▶ **48**

49 Enter the amount of line 48 you want: **Credited to 2000 estimated tax ▶** **Refunded ▶** **49**

Part V Statements Regarding Certain Activities and Other Information (See instructions on page 14.)

		Yes	No
1	At any time during the 1999 calendar year, did the organization have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? If "Yes," the organization may have to file Form TD F 90-22.1. If "Yes," enter the name of the foreign country here ▶		
2	During the tax year, did the organization receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," see page 14 of the instructions for other forms the organization may have to file.		
3	Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $		

SCHEDULE A—COST OF GOODS SOLD (See instructions on page 15.)

Method of inventory valuation (specify) ▶

1 Inventory at beginning of year **1**
2 Purchases **2**
3 Cost of labor **3**
4a Additional section 263A costs (attach schedule) **4a**
b Other costs (attach schedule) **4b**
5 **Total**—Add lines 1 through 4b **5**
6 Inventory at end of year **6**
7 **Cost of goods sold.** Subtract line 6 from line 5. (Enter here and on line 2, Part I.) **7**
8 Do the rules of section 263A (with respect to property produced or acquired for resale) apply to the organization? Yes No

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer or fiduciary Date ▶ Title

Paid Preparer's Use Only

Preparer's signature ▶ Date Check if self-employed ▶ ☐ Preparer's SSN or PTIN

Firm's name (or yours, if self-employed) and address ▶ EIN ▶ ZIP code ▶

Form **990-T** (1999)

Form 990-T (1999) Page **3**

SCHEDULE C—RENT INCOME (FROM REAL PROPERTY AND PERSONAL PROPERTY LEASED WITH REAL PROPERTY)
(See instructions on page 15.)

1 Description of property

(1)
(2)
(3)
(4)

2 Rent received or accrued		3 Deductions directly connected with the income in columns 2(a) and 2(b) (attach schedule)
(a) From personal property (if the percentage of rent for personal property is more than 10% but not more than 50%)	**(b)** From real and personal property (if the percentage of rent for personal property exceeds 50% or if the rent is based on profit or income)	
(1)		
(2)		
(3)		
(4)		
Total	Total	
Total income (Add totals of columns 2(a) and 2(b). Enter here and on line 6, column (A), Part I, page 1.) ▶		**Total deductions.** Enter here and on line 6, column (B), Part I, page 1 ▶

SCHEDULE E—UNRELATED DEBT-FINANCED INCOME (See instructions on page 15.)

1 Description of debt-financed property	2 Gross income from or allocable to debt-financed property	3 Deductions directly connected with or allocable to debt-financed property	
		(a) Straight line depreciation (attach schedule)	**(b)** Other deductions (attach schedule)
(1)			
(2)			
(3)			
(4)			

4 Amount of average acquisition debt on or allocable to debt-financed property (attach schedule)	**5** Average adjusted basis of or allocable to debt-financed property (attach schedule)	**6** Column 4 divided by column 5	**7** Gross income reportable (column 2 × column 6)	**8** Allocable deductions (column 6 × total of columns 3(a) and 3(b))
(1)		%		
(2)		%		
(3)		%		
(4)		%		
Totals ▶			Enter here and on line 7, column (A), Part I, page 1.	Enter here and on line 7, column (B), Part I, page 1.
Total dividends-received deductions included in column 8 ▶				

SCHEDULE F—INTEREST, ANNUITIES, ROYALTIES, AND RENTS FROM CONTROLLED ORGANIZATIONS
(See instructions on page 16.)

1 Name and address of controlled organization(s)	2 Gross income from controlled organization(s)	3 Deductions of controlling organization directly connected with column 2 income (attach schedule)	4 Exempt controlled organizations		
			(a) Unrelated business taxable income	**(b)** Taxable income computed as though not exempt under sec. 501(a), or the amount in col. (a), whichever is larger	**(c)** column (a) divided by column (b)
(1)					%
(2)					%
(3)					%
(4)					%

5 Nonexempt controlled organizations			6 Gross income reportable (column 2 × column 4(c) or column 5(c))	7 Allowable deductions (column 3 × column 4(c) or column 5(c))
(a) Excess taxable income	**(b)** Taxable income, or amount in column (a), whichever is larger	**(c)** Column (a) divided by column (b)		
(1)		%		
(2)		%		
(3)		%		
(4)		%		
Totals ▶			Enter here and include on line 8, column (A), Part I, page 1.	Enter here and include on line 8, column (B), Part I, page 1.

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SCHEDULE G—INVESTMENT INCOME OF A SECTION 501(c)(7), (9), OR (17) ORGANIZATION
(See instructions on page 17.)

1 Description of income	2 Amount of income	3 Deductions directly connected (attach schedule)	4 Set-asides (attach schedule)	5 Total deductions and set-asides (col. 3 plus col. 4)
(1)				
(2)				
(3)				
(4)				
Totals . . . . ▶	Enter here and on line 9, column (A), Part I, page 1.			Enter here and on line 9, column (B), Part I, page 1.

SCHEDULE I—EXPLOITED EXEMPT ACTIVITY INCOME, OTHER THAN ADVERTISING INCOME
(See instructions on page 17.)

1 Description of exploited activity	2 Gross unrelated business income from trade or business	3 Expenses directly connected with production of unrelated business income	4 Net income (loss) from unrelated trade or business (column 2 minus column 3). If a gain, compute cols. 5 through 7.	5 Gross income from activity that is not unrelated business income	6 Expenses attributable to column 5	7 Excess exempt expenses (column 6 minus column 5, but not more than column 4).
(1)						
(2)						
(3)						
(4)						
Column totals . . . . ▶	Enter here and on line 10, col. (A), Part I, page 1.	Enter here and on line 10, col. (B), Part I, page 1.				Enter here and on line 26, Part II, page 1.

SCHEDULE J—ADVERTISING INCOME (See instructions on page 18.)

Part I **Income From Periodicals Reported on a Consolidated Basis**

1 Name of periodical	2 Gross advertising income	3 Direct advertising costs	4 Advertising gain or (loss) (col. 2 minus col. 3). If a gain, compute cols. 5 through 7.	5 Circulation income	6 Readership costs	7 Excess readership costs (column 6 minus column 5, but not more than column 4).
(1)						
(2)						
(3)						
(4)						
Column totals (carry to Part II, line (5)) . . . . ▶						

Part II **Income From Periodicals Reported on a Separate Basis** (For each periodical listed in Part II, fill in columns 2 through 7 on a line-by-line basis.)

(1)						
(2)						
(3)						
(4)						
(5) **Totals from Part I**						
Column totals, Part II . . . . ▶	Enter here and on line 11, col. (A), Part I, page 1.	Enter here and on line 11, col. (B), Part I, page 1.				Enter here and on line 27, Part II, page 1.

SCHEDULE K—COMPENSATION OF OFFICERS, DIRECTORS, AND TRUSTEES (See instructions on page 18.)

1 Name	2 Title	3 Percent of time devoted to business	4 Compensation attributable to unrelated business
		%	
		%	
		%	
		%	
Total—Enter here and on line 14, Part II, page 1. . . . . ▶			

Form **990-T** (1999)

Form **1023**
(Rev. September 1998)
Department of the Treasury
Internal Revenue Service

Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code

OMB No 1545-0056

Note: *If exempt status is approved, this application will be open for public inspection.*

Read the instructions for each Part carefully.
A User Fee must be attached to this application.
If the required information and appropriate documents are not submitted along with Form 8718 (with payment of the appropriate user fee), the application may be returned to you.
Complete the Procedural Checklist on page 8 of the instructions.

Part I Identification of Applicant

1a Full name of organization (as shown in organizing document)	**2** Employer identification number (EIN) (If none, see page 3 of the **Specific Instructions.**)
1b c/o Name (if applicable)	**3** Name and telephone number of person to be contacted if additional information is needed
1c Address (number and street) — Room/Suite	( )
1d City, town, or post office, state, and ZIP + 4. If you have a foreign address, see **Specific Instructions** for Part I, page 3.	**4** Month the annual accounting period ends
	5 Date incorporated or formed
1e Web site address	**6** Check here if applying under section: **a** ☐ 501(e) **b** ☐ 501(f) **c** ☐ 501(k) **d** ☐ 501(n)

7 Did the organization previously apply for recognition of exemption under this Code section or under any other section of the Code? . . . ☐ **Yes** ☐ **No**
If "Yes," attach an explanation.

8 Is the organization required to file Form 990 (or Form 990-EZ)? . . . ☐ **N/A** ☐ **Yes** ☐ **No**
If "No," attach an explanation (see page 3 of the **Specific Instructions**).

9 Has the organization filed Federal income tax returns or exempt organization information returns? . . ☐ **Yes** ☐ **No**
If "Yes," state the form numbers, years filed, and Internal Revenue office where filed.

10 Check the box for the type of organization. ATTACH A CONFORMED COPY OF THE CORRESPONDING ORGANIZING DOCUMENTS TO THE APPLICATION BEFORE MAILING. (See **Specific Instructions** for Part I, Line 10, on page 3.) See also Pub. 557 for examples of organizational documents.)

a ☐ Corporation—Attach a copy of the Articles of Incorporation (including amendments and restatements) showing approval by the appropriate state official; also include a copy of the bylaws.

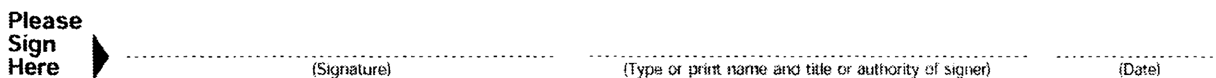
b ☐ Trust— Attach a copy of the Trust Indenture or Agreement, including all appropriate signatures and dates.

c ☐ Association— Attach a copy of the Articles of Association, Constitution, or other creating document, with a declaration (see instructions) or other evidence the organization was formed by adoption of the document by more than one person; also include a copy of the bylaws.

If the organization is a corporation or an unincorporated association that has not yet adopted bylaws, check here ▶ ☐

I declare under the penalties of perjury that I am authorized to sign this application on behalf of the above organization and that I have examined this application, including the accompanying schedules and attachments, and to the best of my knowledge it is true, correct, and complete.

Please Sign Here ▶



For Paperwork Reduction Act Notice, see page 7 of the instructions. Cat. No. 17133K

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Part II **Activities and Operational Information**

1 Provide a detailed narrative description of all the activities of the organization—past, present, and planned. **Do not merely refer to or repeat the language in the organizational document.** List each activity separately in the order of importance based on the relative time and other resources devoted to the activity. Indicate the percentage of time for each activity. Each description should include, as a minimum, the following: **(a)** a detailed description of the activity including its purpose and how each acitivity furthers your exempt purpose; **(b)** when the activity was or will be initiated; and **(c)** where and by whom the activity will be conducted.

2 What are or will be the organization's sources of financial support? List in order of size.

3 Describe the organization's fundraising program, both actual and planned, and explain to what extent it has been put into effect. Include details of fundraising activities such as selective mailings, formation of fundraising committees, use of volunteers or professional fundraisers, etc. Attach representative copies of solicitations for financial support.

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Part II **Activities and Operational Information** *(Continued)*

4 Give the following information about the organization's governing body:

a Names, addresses, and titles of officers, directors, trustees, etc.	**b** Annual compensation

c Do any of the above persons serve as members of the governing body by reason of being public officials or being appointed by public officials? . . . . ☐ **Yes** ☐ **No**

If "Yes," name those persons and explain the basis of their selection or appointment.

d Are any members of the organization's governing body "disqualified persons" with respect to the organization (other than by reason of being a member of the governing body) or do any of the members have either a business or family relationship with "disqualified persons"? (See **Specific Instructions** for Part II, Line 4d, on page 3.) . . . . ☐ **Yes** ☐ **No**

If "Yes," explain.

5 Does the organization control or is it controlled by any other organization? . . . . ☐ **Yes** ☐ **No**

Is the organization the outgrowth of (or successor to) another organization, or does it have a special relationship with another organization by reason of interlocking directorates or other factors? . . . . . ☐ **Yes** ☐ **No**

If either of these questions is answered "Yes," explain.

6 Does or will the organization directly or indirectly engage in any of the following transactions with any political organization or other exempt organization (other than a 501(c)(3) organization): **(a)** grants; **(b)** purchases or sales of assets; **(c)** rental of facilities or equipment; **(d)** loans or loan guarantees; **(e)** reimbursement arrangements; **(f)** performance of services, membership, or fundraising solicitations; or **(g)** sharing of facilities, equipment, mailing lists or other assets, or paid employees? . . . . ☐ **Yes** ☐ **No**

If "Yes," explain fully and identify the other organizations involved.

7 Is the organization financially accountable to any other organization? . . . . ☐ **Yes** ☐ **No**

If "Yes," explain and identify the other organization. Include details concerning accountability or attach copies of reports if any have been submitted.

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Part II **Activities and Operational Information** *(Continued)*

8 What assets does the organization have that are used in the performance of its exempt function? (Do not include property producing investment income.) If any assets are not fully operational, explain their status, what additional steps remain to be completed, and when such final steps will be taken. If none, indicate "N/A."

9 Will the organization be the beneficiary of tax-exempt bond financing within the next 2 years? . . . . ☐ **Yes** ☐ **No**

10a Will any of the organization's facilities or operations be managed by another organization or individual under a contractual agreement? . . . . ☐ **Yes** ☐ **No**

b Is the organization a party to any leases? . . . . ☐ **Yes** ☐ **No**

If either of these questions is answered "Yes," attach a copy of the contracts and explain the relationship between the applicant and the other parties.

11 Is the organization a membership organization? . . . . ☐ **Yes** ☐ **No**

If "Yes," complete the following:

a Describe the organization's membership requirements and attach a schedule of membership fees and dues.

b Describe the organization's present and proposed efforts to attract members and attach a copy of any descriptive literature or promotional material used for this purpose.

c What benefits do (or will) the members receive in exchange for their payment of dues?

12a If the organization provides benefits, services, or products, are the recipients required, or will they be required, to pay for them? . . . . ☐ **N/A** ☐ **Yes** ☐ **No**

If "Yes," explain how the charges are determined and attach a copy of the current fee schedule.

b Does or will the organization limit its benefits, services, or products to specific individuals or classes of individuals? . . . . ☐ **N/A** ☐ **Yes** ☐ **No**

If "Yes," explain how the recipients or beneficiaries are or will be selected.

13 Does or will the organization attempt to influence legislation? . . . . ☐ **Yes** ☐ **No**

If "Yes," explain. Also, give an estimate of the percentage of the organization's time and funds that it devotes or plans to devote to this activity.

14 Does or will the organization intervene in any way in political campaigns, including the publication or distribution of statements? . . . . ☐ **Yes** ☐ **No**

If "Yes," explain fully.

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Part III Technical Requirements

1 Are you filing Form 1023 within 15 months from the end of the month in which your organization was created or formed? . . . . ☐ **Yes** ☐ **No**

If you answer "Yes," do not answer questions on lines 2 through 6 below.

2 If one of the exceptions to the 15-month filing requirement shown below applies, check the appropriate box and proceed to question 7.

Exceptions—You are not required to file an exemption application within 15 months if the organization:

☐ **a** Is a church, interchurch organization of local units of a church, a convention or association of churches, or an integrated auxiliary of a church. See **Specific Instructions,** Line 2a, on page 4;

☐ **b** Is not a private foundation and normally has gross receipts of not more than $5,000 in each tax year; or

☐ **c** Is a subordinate organization covered by a group exemption letter, but only if the parent or supervisory organization timely submitted a notice covering the subordinate.

3 If the organization does not meet any of the exceptions on line 2 above, are you filing Form 1023 within 27 months from the end of the month in which the organization was created or formed?. . . . . . ☐ **Yes** ☐ **No**

If "Yes," your organization qualifies under Regulation section 301.9100-2, for an automatic 12-month extension of the 15-month filing requirement. Do not answer questions 4 through 6.

If "No," answer question 4.

4 If you answer "No" to question 3, does the organization wish to request an extension of time to apply under the "reasonable action and good faith" and the "no prejudice to the interest of the government" requirements of Regulations section 301.9100-3? . . . . ☐ **Yes** ☐ **No**

If "Yes," give the reasons for not filing this application within the 27-month period described in question 3. See **Specific Instructions,** Part III, Line 4, before completing this item. Do not answer questions 5 and 6.

If "No," answer questions 5 and 6.

5 If you answer "No" to question 4, your organization's qualification as a section 501(c)(3) organization can be recognized only from the date this application is filed. Therefore, do you want us to consider the application as a request for recognition of exemption as a section 501(c)(3) organization from the date the application is received and not retroactively to the date the organization was created or formed? . ☐ **Yes** ☐ **No**

6 If you answer "Yes" to question 5 above and wish to request recognition of section 501(c)(4) status for the period beginning with the date the organization was formed and ending with the date the Form 1023 application was received (the effective date of the organization's section 501(c)(3) status), check here ▶ ☐ and attach a completed page 1 of Form 1024 to this application.

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Part III **Technical Requirements** *(Continued)*

7 Is the organization a private foundation?
☐ **Yes** (Answer question 8.)
☐ **No** (Answer question 9 and proceed as instructed.)

8 If you answer "Yes" to question 7, does the organization claim to be a private operating foundation?
☐ **Yes** (Complete Schedule E.)
☐ **No**

After answering question 8 on this line, go to line 14 on page 7.

9 If you answer "No" to question 7, indicate the public charity classification the organization is requesting by checking the box below that most appropriately applies:

THE ORGANIZATION IS NOT A PRIVATE FOUNDATION BECAUSE IT QUALIFIES:

a	☐	As a church or a convention or association of churches (CHURCHES MUST COMPLETE SCHEDULE A.)	Sections 509(a)(1) and 170(b)(1)(A)(i)
b	☐	As a school (MUST COMPLETE SCHEDULE B.)	Sections 509(a)(1) and 170(b)(1)(A)(ii)
c	☐	As a hospital or a cooperative hospital service organization, or a medical research organization operated in conjunction with a hospital (These organizations, except for hospital service organizations, MUST COMPLETE SCHEDULE C.)	Sections 509(a)(1) and 170(b)(1)(A)(iii)
d	☐	As a governmental unit described in section 170(c)(1).	Sections 509(a)(1) and 170(b)(1)(A)(v)
e	☐	As being operated solely for the benefit of, or in connection with, one or more of the organizations described in **a** through **d, g, h,** or **i** (MUST COMPLETE SCHEDULE D.)	Section 509(a)(3)
f	☐	As being organized and operated exclusively for testing for public safety.	Section 509(a)(4)
g	☐	As being operated for the benefit of a college or university that is owned or operated by a governmental unit.	Sections 509(a)(1) and 170(b)(1)(A)(iv)
h	☐	As receiving a substantial part of its support in the form of contributions from publicly supported organizations, from a governmental unit, or from the general public.	Sections 509(a)(1) and 170(b)(1)(A)(vi)
i	☐	As normally receiving not more than one-third of its support from gross investment income and more than one-third of its support from contributions, membership fees, and gross receipts from activities related to its exempt functions (subject to certain exceptions).	Section 509(a)(2)
j	☐	The organization is a publicly supported organization but is not sure whether it meets the public support test of **h** or **i**. The organization would like the IRS to decide the proper classification.	Sections 509(a)(1) and 170(b)(1)(A)(vi) or Section 509(a)(2)

If you checked one of the boxes a through f in question 9, go to question 14. If you checked box g in question 9, go to questions 11 and 12. If you checked box h, i, or j, in question 9, go to question 10.

Part III **Technical Requirements** *(Continued)*

10 If you checked box **h, i,** or **j** in question 9, has the organization completed a tax year of at least 8 months?

☐ **Yes**—Indicate whether you are requesting:

☐ A definitive ruling. (Answer questions 11 through 14.)

☐ An advance ruling. (Answer questions 11 and 14 and attach two Forms 872-C completed and signed.)

☐ **No—You must request an advance ruling by completing and signing two Forms 872-C and attaching them to the Form 1023.**

11 If the organization received any unusual grants during any of the tax years shown in Part IV-A, **Statement of Revenue and Expenses,** attach a list for each year showing the name of the contributor; the date and the amount of the grant; and a brief description of the nature of the grant.

12 If you are requesting a definitive ruling under section 170(b)(1)(A)(iv) or (vi), check here ▶ ☐ and:

a Enter 2% of line 8, column (e), Total, of Part IV-A . . . . ________

b Attach a list showing the name and amount contributed by each person (other than a governmental unit or "publicly supported" organization) whose total gifts, grants, contributions, etc., were more than the amount entered on line **12a** above.

13 If you are requesting a definitive ruling under section 509(a)(2), check here ▶ ☐ and:

a For each of the years included on lines 1, 2, and 9 of Part IV-A, attach a list showing the name of and amount received from each "disqualified person." (For a definition of "disqualified person," see **Specific Instructions,** Part II, Line 4d, on page 3.)

b For each of the years included on line 9 of Part IV-A, attach a list showing the name of and amount received from each payer (other than a "disqualified person") whose payments to the organization were more than $5,000. For this purpose, "payer" includes, but is not limited to, any organization described in sections 170(b)(1)(A)(i) through (vi) and any governmental agency or bureau.

14 Indicate if your organization is one of the following. If so, complete the required schedule. (Submit only those schedules that apply to your organization. **Do not submit blank schedules.**)	**Yes**	**No**	**If "Yes," complete Schedule:**
Is the organization a church?			A
Is the organization, or any part of it, a school?			B
Is the organization, or any part of it, a hospital or medical research organization?			C
Is the organization a section 509(a)(3) supporting organization?			D
Is the organization a private operating foundation?.			E
Is the organization, or any part of it, a home for the aged or handicapped?			F
Is the organization, or any part of it, a child care organization?.			G
Does the organization provide or administer any scholarship benefits, student aid, etc.?			H
Has the organization taken over, or will it take over, the facilities of a "for profit" institution? . . .			I

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Part IV **Financial Data**

Complete the financial statements for the current year and for each of the 3 years immediately before it. If in existence less than 4 years, complete the statements for each year in existence. **If in existence less than 1 year, also provide proposed budgets for the 2 years following the current year.**

A. Statement of Revenue and Expenses

		Current tax year	3 prior tax years or proposed budget for 2 years			
		(a) From ...... to	**(b)**	**(c)**	**(d)**	**(e) TOTAL**
Revenue	**1** Gifts, grants, and contributions received (not including unusual grants—see page 6 of the instructions)					
	2 Membership fees received					
	3 Gross investment income (see instructions for definition)					
	4 Net income from organization's unrelated business activities not included on line 3					
	5 Tax revenues levied for and either paid to or spent on behalf of the organization					
	6 Value of services or facilities furnished by a governmental unit to the organization without charge (not including the value of services or facilities generally furnished the public without charge)					
	7 Other income (not including gain or loss from sale of capital assets) (attach schedule)					
	8 **Total** (add lines 1 through 7)					
	9 Gross receipts from admissions, sales of merchandise or services, or furnishing of facilities in any activity that is not an unrelated business within the meaning of section 513. Include related cost of sales on line 22					
	10 **Total** (add lines 8 and 9)					
	11 Gain or loss from sale of capital assets (attach schedule)					
	12 Unusual grants					
	13 **Total** revenue (add lines 10 through 12)					
Expenses	**14** Fundraising expenses					
	15 Contributions, gifts, grants, and similar amounts paid (attach schedule)					
	16 Disbursements to or for benefit of members (attach schedule)					
	17 Compensation of officers, directors, and trustees (attach schedule)					
	18 Other salaries and wages					
	19 Interest					
	20 Occupancy (rent, utilities, etc.)					
	21 Depreciation and depletion					
	22 Other (attach schedule)					
	23 **Total** expenses (add lines 14 through 22)					
	24 Excess of revenue over expenses (line 13 minus line 23)					

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Part IV **Financial Data** *(Continued)*

B. Balance Sheet (at the end of the period shown)		**Current tax year** Date ....
Assets		
1 Cash	1	
2 Accounts receivable, net	2	
3 Inventories	3	
4 Bonds and notes receivable (attach schedule)	4	
5 Corporate stocks (attach schedule)	5	
6 Mortgage loans (attach schedule)	6	
7 Other investments (attach schedule)	7	
8 Depreciable and depletable assets (attach schedule)	8	
9 Land	9	
10 Other assets (attach schedule)	10	
11 **Total assets** (add lines 1 through 10)	11	
Liabilities		
12 Accounts payable	12	
13 Contributions, gifts, grants, etc., payable	13	
14 Mortgages and notes payable (attach schedule)	14	
15 Other liabilities (attach schedule)	15	
16 **Total liabilities** (add lines 12 through 15)	16	
Fund Balances or Net Assets		
17 Total fund balances or net assets	17	
18 **Total liabilities and fund balances or net assets** (add line 16 and line 17)	18	

If there has been any substantial change in any aspect of the organization's financial activities since the end of the period shown above, check the box and attach a detailed explanation . . . ▶ ☐

Form 1023 (Rev. 9-98) Page **11**

Schedule A. Churches

1 Provide a brief history of the development of the organization, including the reasons for its formation.

2 Does the organization have a written creed or statement of faith? . . . . ☐ **Yes** ☐ **No**

If "Yes," attach a copy.

3 Does the organization require prospective members to renounce other religious beliefs or their membership in other churches or religious orders to become members? . . . . ☐ **Yes** ☐ **No**

4 Does the organization have a formal code of doctrine and discipline for its members? . . . . ☐ **Yes** ☐ **No**

If "Yes," describe.

5 Describe the form of worship and attach a schedule of worship services.

6 Are the services open to the public? . . . . ☐ **Yes** ☐ **No**

If "Yes," describe how the organization publicizes its services and explain the criteria for admittance.

7 Explain how the organization attracts new members.

8 **(a)** How many active members are currently enrolled in the church?

(b) What is the average attendance at the worship services?

9 In addition to worship services, what other religious services (such as baptisms, weddings, funerals, etc.) does the organization conduct?

Schedule A. Churches *(Continued)*

10 Does the organization have a school for the religious instruction of the young? . . . . ☐ **Yes** ☐ **No**

11 Were the current deacons, minister, and/or pastor formally ordained after a prescribed course of study? . . . . ☐ **Yes** ☐ **No**

12 Describe the organization's religious hierarchy or ecclesiastical government.

13 Does the organization have an established place of worship? . . . . ☐ **Yes** ☐ **No**

If "Yes," provide the name and address of the owner or lessor of the property and the address and a description of the facility.

If the organization has no regular place of worship, state where the services are held and how the site is selected.

14 Does (or will) the organization license or otherwise ordain ministers (or their equivalent) or issue church charters? . . . . ☐ **Yes** ☐ **No**

If "Yes," describe in detail the requirements and qualifications needed to be so licensed, ordained, or chartered.

15 Did the organization pay a fee for a church charter? . . . . ☐ **Yes** ☐ **No**

If "Yes," state the name and address of the organization to which the fee was paid, attach a copy of the charter, and describe the circumstances surrounding the chartering.

16 Show how many hours a week the minister/pastor and officers each devote to church work and the amount of compensation paid to each of them. If the minister or pastor is otherwise employed, indicate by whom employed, the nature of the employment, and the hours devoted to that employment.

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Schedule A. Churches *(Continued)*

17 Will any funds or property of the organization be used by any officer, director, employee, minister, or pastor for his or her personal needs or convenience? ☐ **Yes** ☐ **No**

If "Yes," describe the nature and circumstances of such use.

18 List any officers, directors, or trustees related by blood or marriage.

19 Give the name of anyone who has assigned income to the organization or made substantial contributions of money or other property. Specify the amounts involved.

Instructions

Although a church, its integrated auxiliaries, or a convention or association of churches is not required to file Form 1023 to be exempt from Federal income tax or to receive tax-deductible contributions, such an organization may find it advantageous to obtain recognition of exemption. In this event, you should submit information showing that your organization is a church, synagogue, association or convention of churches, religious order or religious organization that is an integral part of a church, and that it is carrying out the functions of a church.

In determining whether an admittedly religious organization is also a church, the IRS does not accept any and every assertion that such an organization is a church. Because beliefs and practices vary so widely, there is no single definition of the word "church" for tax purposes. The IRS considers the facts and circumstances of each organization applying for church status.

The IRS maintains two basic guidelines in determining that an organization meets the religious purposes test:

1. That the particular religious beliefs of the organization are truly and sincerely held, and

2. That the practices and rituals associated with the organization's religious beliefs or creed are not illegal or contrary to clearly defined public policy.

In order for the IRS to properly evaluate your organization's activities and religious purposes, it is important that all questions in Schedule A be answered.

The information submitted with Schedule A will be a determining factor in granting the "church" status requested by your organization. In completing the schedule, consider the following points:

1. The organization's activities in furtherance of its beliefs must be exclusively religious, and

2. An organization will not qualify for exemption if it has a substantial nonexempt purpose of serving the private interests of its founder or the founder's family.

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Schedule B. Schools, Colleges, and Universities

1 Does, or will, the organization normally have: **(a)** a regularly scheduled curriculum, **(b)** a regular faculty of qualified teachers, **(c)** a regularly enrolled student body, and **(d)** facilities where its educational activities are regularly carried on? . . . . ☐ **Yes** ☐ **No**
If "No," do not complete the rest of Schedule B.

2 Is the organization an instrumentality of a state or political subdivision of a state? . . . . ☐ **Yes** ☐ **No**
If "Yes," document this in Part II and do not complete items 3 through 10 of Schedule B. (See instructions on the back of Schedule B.)

3 Does or will the organization (or any department or division within it) discriminate in any way on the basis of race with respect to:

a Admissions? . . . . ☐ **Yes** ☐ **No**
b Use of facilities or exercise of student privileges? . . . . ☐ **Yes** ☐ **No**
c Faculty or administrative staff? . . . . ☐ **Yes** ☐ **No**
d Scholarship or loan programs? . . . . ☐ **Yes** ☐ **No**
If "Yes" for any of the above, explain.

4 Does the organization include a statement in its charter, bylaws, or other governing instrument, or in a resolution of its governing body, that it has a racially nondiscriminatory policy as to students? . . . . ☐ **Yes** ☐ **No**

Attach whatever corporate resolutions or other official statements the organization has made on this subject.

5a Has the organization made its racially nondiscriminatory policies known in a manner that brings the policies to the attention of all segments of the general community that it serves? . . . . ☐ **Yes** ☐ **No**

If "Yes," describe how these policies have been publicized and how often relevant notices or announcements have been made. If no newspaper or broadcast media notices have been used, explain.

b If applicable, attach clippings of any relevant newspaper notices or advertising, or copies of tapes or scripts used for media broadcasts. Also attach copies of brochures and catalogs dealing with student admissions, programs, and scholarships, as well as representative copies of all written advertising used as a means of informing prospective students of the organization's programs.

6 Attach a numerical schedule showing the racial composition, as of the current academic year, and projected to the extent feasible for the next academic year, of: **(a)** the student body, and **(b)** the faculty and administrative staff.

7 Attach a list showing the amount of any scholarship and loan funds awarded to students enrolled and the racial composition of the students who have received the awards.

8a Attach a list of the organization's incorporators, founders, board members, and donors of land or buildings, whether individuals or organizations.

b State whether any of the organizations listed in **8a** have as an objective the maintenance of segregated public or private school education, and, if so, whether any of the individuals listed in **8a** are officers or active members of such organizations.

9a Enter the public school district and county in which the organization is located.

b Was the organization formed or substantially expanded at the time of public school desegregation in the above district or county? . . . . ☐ **Yes** ☐ **No**

10 Has the organization ever been determined by a state or Federal administrative agency or judicial body to be racially discriminatory? . . . . ☐ **Yes** ☐ **No**

If "Yes," attach a detailed explanation identifying the parties to the suit, the forum in which the case was heard, the cause of action, the holding in the case, and the citations (if any) for the case. Also describe in detail what changes in the organization's operation, if any, have occurred since then.

For more information, see back of Schedule B.

Instructions

A "school" is an organization that has the primary function of presenting formal instruction, normally maintains a regular faculty and curriculum, normally has a regularly enrolled student body, and has a place where its educational activities are carried on.

The term generally corresponds to the definition of an "educational organization" in section 170(b)(1)(A)(ii). Thus, the term includes primary, secondary, preparatory and high schools, and colleges and universities. The term does not include organizations engaged in both educational and noneducational activities unless the latter are merely incidental to the educational activities. A school for handicapped children is included within the term, but an organization merely providing handicapped children with custodial care is not.

For purposes of Schedule B, "Sunday schools" that are conducted by a church are not included in the term "schools," but separately organized schools (such as parochial schools, universities, and similar institutions) are included in the term.

A private school that otherwise meets the requirements of section 501(c)(3) as an educational institution will not qualify for exemption under section 501(a) unless it has a racially nondiscriminatory policy as to students.

This policy means that the school admits students of any race to all the rights, privileges, programs, and activities generally accorded or made available to students at that school and that the school does not discriminate on the basis of race in the administration of its educational policies, admissions policies, scholarship and loan programs, and athletic or other school-administered programs.

The IRS considers discrimination on the basis of race to include discrimination on the basis of color and national or ethnic origin. A policy of a school that favors racial minority groups in admissions, facilities, programs, and financial assistance will not constitute discrimination on the basis of race when the purpose and effect is to promote the establishment and maintenance of that school's racially nondiscriminatory policy as to students.

See Rev. Proc. 75-50, 1975-2 C.B. 587, for guidelines and recordkeeping requirements for determining whether private schools that are applying for recognition of exemption have racially nondiscriminatory policies as to students.

Line 2

An instrumentality of a state or political subdivision of a state may qualify under section 501(c)(3) if it is organized as a separate entity from the governmental unit that created it and if it otherwise meets the organizational and operational tests of section 501(c)(3). See Rev. Rul. 60-384, 1960-2 C.B. 172. Any such organization that is a school is not a private school and, therefore, is not subject to the provisions of Rev. Proc. 75-50.

Schools that incorrectly answer "Yes" to line 2 will be contacted to furnish the information called for by lines 3 through 10 in order to establish that they meet the requirements for exemption. To prevent delay in the processing of your application, be sure to answer line 2 correctly and complete lines 3 through 10, if applicable.

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Schedule C. Hospitals and Medical Research Organizations

☐ Check here if claiming to be a hospital; complete the questions in Section I of this schedule; and write "N/A" in Section II.
☐ Check here if claiming to be a medical research organization operated in conjunction with a hospital; complete the questions in Section II of this schedule; and write "N/A" in Section I.

Section I **Hospitals**

1a How many doctors are on the hospital's courtesy staff? . . . . ____________

b Are all the doctors in the community eligible for staff privileges? . . . . ☐ Yes ☐ No
If "No," give the reasons why and explain how the courtesy staff is selected.

2a Does the hospital maintain a full-time emergency room?. . . . . ☐ Yes ☐ No
b What is the hospital's policy on administering emergency services to persons without apparent means to pay?

c Does the hospital have any arrangements with police, fire, and voluntary ambulance services for the delivery or admission of emergency cases? . . . . ☐ Yes ☐ No
Explain.

3a Does or will the hospital require a deposit from persons covered by Medicare or Medicaid in its admission practices? . . . . ☐ Yes ☐ No
If "Yes," explain.

b Does the same deposit requirement, if any, apply to all other patients?. . . . . ☐ Yes ☐ No
If "No," explain.

4 Does or will the hospital provide for a portion of its services and facilities to be used for charity patients? ☐ Yes ☐ No
Explain the policy regarding charity cases. Include data on the hospital's past experience in admitting charity patients and arrangements it may have with municipal or government agencies for absorbing the cost of such care.

5 Does or will the hospital carry on a formal program of medical training and research?. . . . . . . ☐ Yes ☐ No
If "Yes," describe.

6 Does the hospital provide office space to physicians carrying on a medical practice? . . . . ☐ Yes ☐ No
If "Yes," attach a list setting forth the name of each physician, the amount of space provided, the annual rent, the expiration date of the current lease and whether the terms of the lease represent fair market value.

Section II **Medical Research Organizations**

1 Name the hospitals with which the organization has a relationship and describe the relationship.

2 Attach a schedule describing the organization's present and proposed (indicate which) medical research activities; show the nature of the activities, and the amount of money that has been or will be spent in carrying them out. (Making grants to other organizations is not direct conduct of medical research.)

3 Attach a statement of assets showing their fair market value and the portion of the assets directly devoted to medical research.

For more information, see back of Schedule C.

Additional Information

Hospitals

To be entitled to status as a "hospital," an organization must have, as its principal purpose or function, the providing of medical or hospital care or medical education or research. "Medical care" includes the treatment of any physical or mental disability or condition, the cost of which may be taken as a deduction under section 213, whether the treatment is performed on an inpatient or outpatient basis. Thus, a rehabilitation institution, outpatient clinic, or community mental health or drug treatment center may be a hospital if its principal function is providing the above-described services.

On the other hand, a convalescent home or a home for children or the aged is not a hospital. Similarly, an institution whose principal purpose or function is to train handicapped individuals to pursue some vocation is not a hospital. Moreover, a medical education or medical research institution is not a hospital, unless it is also actively engaged in providing medical or hospital care to patients on its premises or in its facilities on an inpatient or outpatient basis.

Cooperative Hospital Service Organizations

Cooperative hospital service organizations (section 501(e)) should not complete Schedule C.

Medical Research Organizations

To qualify as a medical research organization, the principal function of the organization must be the direct, continuous, and active conduct of medical research in conjunction with a hospital that is described in section 501(c)(3), a Federal hospital, or an instrumentality of a governmental unit referred to in section 170(c)(1).

For purposes of section 170(b)(1)(A)(iii) only, the organization must be set up to use the funds it receives in the active conduct of medical research by January 1 of the fifth calendar year after receipt. The arrangement it has with donors to assure use of the funds within the 5-year period must be legally enforceable.

As used here, "medical research" means investigations, experiments, and studies to discover, develop, or verify knowledge relating to the causes, diagnosis, treatment, prevention, or control of human physical or mental diseases and impairments.

For further information, see Regulations section 1.170A-9(c)(2).

Schedule D. Section 509(a)(3) Supporting Organizations

1a Organizations supported by the applicant organization: Name and address of supported organization	b Has the supported organization received a ruling or determination letter that it is not a private foundation by reason of section 509(a)(1) or (2)?	
	☐ Yes	☐ No
	☐ Yes	☐ No
	☐ Yes	☐ No
	☐ Yes	☐ No
	☐ Yes	☐ No

c If "No" for any of the organizations listed in **1a**, explain.

2 Does the supported organization have tax-exempt status under section 501(c)(4), 501(c)(5), or 501(c)(6)? ☐ **Yes** ☐ **No**
If "Yes," attach: **(a)** a copy of its ruling or determination letter, and **(b)** an analysis of its revenue for the current year and the preceding 3 years. (Provide the financial data using the formats in Part IV-A (lines 1–13) and Part III (lines 11, 12, and 13).)

3 Does your organization's governing document indicate that the majority of its governing board is elected or appointed by the supported organizations? . . . . ☐ **Yes** ☐ **No**
If "Yes," skip to line 9.
If "No," you must answer the questions on lines 4 through 9.

4 Does your organization's governing document indicate the common supervision or control that it and the supported organizations share? . . . . ☐ **Yes** ☐ **No**
If "Yes," give the article and paragraph numbers. If "No," explain.

5 To what extent do the supported organizations have a significant voice in your organization's investment policies, in the making and timing of grants, and in otherwise directing the use of your organization's income or assets?

6 Does the mentioning of the supported organizations in your organization's governing instrument make it a trust that the supported organizations can enforce under state law and compel to make an accounting? ☐ **Yes** ☐ **No**
If "Yes," explain.

7a What percentage of your organization's income does it pay to each supported organization?

b What is the total annual income of each supported organization?

c How much does your organization contribute annually to each supported organization?

For more information, see back of Schedule D.

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Schedule D. Section 509(a)(3) Supporting Organizations *(Continued)*

8 To what extent does your organization conduct activities that would otherwise be carried on by the supported organizations? Explain why these activities would otherwise be carried on by the supported organizations.

9 Is the applicant organization controlled directly or indirectly by one or more "disqualified persons" (other than one who is a disqualified person solely because he or she is a manager) or by an organization that is not described in section 509(a)(1) or (2)? . . . . ☐ **Yes** ☐ **No**
If "Yes," explain.

Instructions

For an explanation of the types of organizations defined in section 509(a)(3) as being excluded from the definition of a private foundation, see Pub. 557, Chapter 3.

Line 1

List each organization that is supported by your organization and indicate in item **1b** if the supported organization has received a letter recognizing exempt status as a section 501(c)(3) public charity as defined in section 509(a)(1) or 509(a)(2). If you answer "No" in **1b** to any of the listed organizations, please explain in **1c.**

Line 3

Your organization's governing document may be articles of incorporation, articles of association, constitution, trust indenture, or trust agreement.

Line 9

For a definition of a "disqualified person," see **Specific Instructions,** Part II, Line 4d, on page 3 of the application's instructions.

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Schedule E. Private Operating Foundations

Income Test		Most recent tax year
1a Adjusted net income, as defined in Regulations section 53.4942(a)-2(d)	1a	
b Minimum investment return, as defined in Regulations section 53.4942(a)-2(c)	1b	
2 Qualifying distributions:		
a Amounts (including administrative expenses) paid directly for the active conduct of the activities for which organized and operated under section 501(c)(3) (attach schedule)	2a	
b Amounts paid to acquire assets to be used (or held for use) directly in carrying out purposes described in section 170(c)(1) or 170(c)(2)(B) (attach schedule)	2b	
c Amounts set aside for specific projects that are for purposes described in section 170(c)(1) or 170(c)(2)(B) (attach schedule)	2c	
d **Total** qualifying distributions (add lines 2a, b, and c)	2d	
3 Percentages:		
a Percentage of qualifying distributions to adjusted net income (divide line 2d by line 1a)	3a	%
b Percentage of qualifying distributions to minimum investment return (divide line 2d by line 1b). (Percentage must be at least 85% for 3a or 3b)	3b	%
Assets Test		
4 Value of organization's assets used in activities that directly carry out the exempt purposes. Do not include assets held merely for investment or production of income (attach schedule)	4	
5 Value of any stock of a corporation that is controlled by applicant organization and carries out its exempt purposes (attach statement describing corporation)	5	
6 Value of all qualifying assets (add lines 4 and 5)	6	
7 Value of applicant organization's total assets	7	
8 Percentage of qualifying assets to total assets (divide line 6 by line 7—percentage must exceed 65%)	8	%
Endowment Test		
9 Value of assets not used (or held for use) directly in carrying out exempt purposes:		
a Monthly average of investment securities at fair market value	9a	
b Monthly average of cash balances	9b	
c Fair market value of all other investment property (attach schedule)	9c	
d **Total** (add lines 9a, b, and c)	9d	
10 Acquisition indebtedness related to line 9 items (attach schedule)	10	
11 Balance (subtract line 10 from line 9d)	11	
12 Multiply line 11 by 3⅓% (⅔ of the percentage for the minimum investment return computation under section 4942(e)). Line 2d above must equal or exceed the result of this computation	12	
Support Test		
13 Applicant organization's support as defined in section 509(d)	13	
14 Gross investment income as defined in section 509(e)	14	
15 Support for purposes of section 4942(j)(3)(B)(iii) (subtract line 14 from line 13)	15	
16 Support received from the general public, five or more exempt organizations, or a combination of these sources (attach schedule)	16	
17 For persons (other than exempt organizations) contributing more than 1% of line 15, enter the total amounts that are more than 1% of line 15	17	
18 Subtract line 17 from line 16	18	
19 Percentage of total support (divide line 18 by line 15—must be at least 85%)	19	%
20 Does line 16 include support from an exempt organization that is more than 25% of the amount of line 15?		☐ Yes ☐ No

21 Newly created organizations with less than 1 year's experience: Attach a statement explaining how the organization is planning to satisfy the requirements of section 4942(j)(3) for the income test and one of the supplemental tests during its first year's operation. Include a description of plans and arrangements, press clippings, public announcements, solicitations for funds, etc.

22 Does the amount entered on line 2a above include any grants that the applicant organization made? ☐ Yes ☐ No
If "Yes," attach a statement explaining how those grants satisfy the criteria for "significant involvement" grants described in section 53.4942(b)-1(b)(2) of the regulations.

For more information, see back of Schedule E.

Instructions

If the organization claims to be an operating foundation described in section 4942(j)(3) and—

a. Bases its claim to private operating foundation status on normal and regular operations over a period of years; or

b. Is newly created, set up as a private operating foundation, and has at least 1 year's experience;

provide the information under the **income test and under one of the three supplemental tests** (assets, endowment, or support). If the organization does not have at least 1 year's experience, provide the information called for on line 21. If the organization's private operating foundation status depends on its normal and regular operations as described in **a** above, attach a schedule similar to Schedule E showing the data in tabular form for the 3 years preceding the most recent tax year. (See Regulations section 53.4942(b)-1 for additional information before completing the "Income Test" section of this schedule.) Organizations claiming section 4942(j)(5) status must satisfy the income test and the endowment test.

A "private operating foundation" described in section 4942(j)(3) is a private foundation that spends substantially all of the smaller of its adjusted net income (as defined below) or its minimum investment return directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated. The foundation must satisfy the income test under section 4942(j)(3)(A), as modified by Regulations section 53.4942(b)-1, and one of the following three supplemental tests: **(1)** the assets test under section 4942(j)(3)(B)(i); **(2)** the endowment test under section 4942(j)(3)(B)(ii); or **(3)** the support test under section 4942(j)(3)(B)(iii).

Certain long-term care facilities described in section 4942(j)(5) are treated as private operating foundations for purposes of section 4942 only.

"Adjusted net income" is the excess of gross income determined with the income modifications described below for the tax year over the sum of deductions determined with the deduction modifications described below. Items of gross income from any unrelated trade or business and the deductions directly connected with the unrelated trade or business are taken into account in computing the organization's adjusted net income.

Income Modifications

The following are income modifications (adjustments to gross income):

1. Section 103 (relating to interest on certain governmental obligations) does not apply. Thus, interest that otherwise would have been excluded should be included in gross income.

2. Except as provided in **3** below, capital gains and losses are taken into account only to the extent of the net short-term gain. Long-term gains and losses are disregarded.

3. The gross amount received from the sale or disposition of certain property should be included in gross income to the extent that the acquisition of the property constituted a qualifying distribution under section 4942(g)(1)(B).

4. Repayments of prior qualifying distributions (as defined in section 4942(g)(1)(A)) constitute items of gross income.

5. Any amount set aside under section 4942(g)(2) that is "not necessary for the purposes for which it was set aside" constitutes an item of gross income.

Deduction Modifications

The following are deduction modifications (adjustments to deductions):

1. Expenses for the general operation of the organization according to its charitable purposes (as contrasted with expenses for the production or collection of income and management, conservation, or maintenance of income-producing property) should not be taken as deductions. If only a portion of the property is used for production of income subject to section 4942 and the remainder is used for general charitable purposes, the expenses connected with that property should be divided according to those purposes. Only expenses related to the income-producing portion should be taken as deductions.

2. Charitable contributions, deductible under section 170 or 642(c), should not be taken into account as deductions for adjusted net income.

3. The net operating loss deduction prescribed under section 172 should not be taken into account as a deduction for adjusted net income.

4. The special deductions for corporations (such as the dividends-received deduction) allowed under sections 241 through 249 should not be taken into account as deductions for adjusted net income.

5. Depreciation and depletion should be determined in the same manner as under section 4940(c)(3)(B).

Section 265 (relating to the expenses and interest connected with tax-exempt income) should not be taken into account.

You may find it easier to figure adjusted net income by completing column (c), Part 1, Form 990-PF, according to the instructions for that form.

An organization that has been held to be a private operating foundation will continue to be such an organization only if it meets the income test and either the assets, endowment, or support test in later years. See Regulations section 53.4942(b) for additional information. No additional request for ruling will be necessary or appropriate for an organization to maintain its status as a private operating foundation. However, data related to the above tests must be submitted with the organization's annual information return, Form 990-PF.

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Schedule F. Homes for the Aged or Handicapped

1 What are the requirements for admission to residency? Explain fully and attach promotional literature and application forms.

2 Does or will the home charge an entrance or founder's fee? . . . . ☐ **Yes** ☐ **No**
If "Yes," explain and specify the amount charged.

3 What periodic fees or maintenance charges are or will be required of its residents?

4a What established policy does the home have concerning residents who become unable to pay their regular charges?

b What arrangements does the home have or will it make with local and Federal welfare units, sponsoring organizations, or others to absorb all or part of the cost of maintaining those residents?

5 What arrangements does or will the home have to provide for the health needs of its residents?

6 In what way are the home's residential facilities designed to meet some combination of the physical, emotional, recreational, social, religious, and similar needs of the aged or handicapped?

7 Provide a description of the home's facilities and specify both the residential capacity of the home and the current number of residents.

8 Attach a sample copy of the contract or agreement the organization makes with or requires of its residents.

For more information, see back of Schedule F.

Instructions

Line 1

Provide the criteria for admission to the home and submit brochures, pamphlets, or other printed material used to inform the public about the home's admissions policy.

Line 2

Indicate whether the fee charged is an entrance fee or a monthly charge, etc. Also, if the fee is an entrance fee, is it payable in a lump sum or on an installment basis?

Line 4

Indicate the organization's policy regarding residents who are unable to pay. Also, indicate whether the organization is subsidized for all or part of the cost of maintaining those residents who are unable to pay.

Line 5

Indicate whether the organization provides health care to the residents, either directly or indirectly, through some continuing arrangement with other organizations, facilities, or health personnel. If no health care is provided, indicate "N/A."

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Schedule G. Child Care Organizations

1 Is the organization's primary activity the providing of care for children away from their homes? . . . . ☐ Yes ☐ No

2 How many children is the organization authorized to care for by the state (or local governmental unit), and what was the average attendance during the past 6 months, or the number of months the organization has been in existence if less than 6 months?

3 How many children are currently cared for by the organization?

4 Is substantially all (at least 85%) of the care provided for the purpose of enabling parents to be gainfully employed or to seek employment? . . . ☐ Yes ☐ No

5 Are the services provided available to the general public? . . . . ☐ Yes ☐ No
If "No," explain.

6 Indicate the category, or categories, of parents whose children are eligible for the child care services (check as many as apply):

☐ low-income parents

☐ any working parents (or parents looking for work)

☐ anyone with the ability to pay

☐ other (explain)

Instructions

Line 5
If your organization's services are not available to the general public, indicate the particular group or groups that may utilize the services.

REMINDER—If this organization claims to operate a school, then it must also fill out Schedule B.

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Schedule H. Organizations Providing Scholarship Benefits, Student Aid, etc., to Individuals

1a Describe the nature and the amount of the scholarship benefit, student aid, etc., including the terms and conditions governing its use, whether a gift or a loan, and how the availability of the scholarship is publicized. If the organization has established or will establish several categories of scholarship benefits, identify each kind of benefit and explain how the organization determines the recipients for each category. Attach a sample copy of any application the organization requires individuals to complete to be considered for scholarship grants, loans, or similar benefits. (Private foundations that make grants for travel, study, or other similar purposes are required to obtain advance approval of scholarship procedures. See Regulations sections 53.4945-4(c) and (d).)

b If you want this application considered as a request for approval of grant procedures in the event we determine that the organization is a private foundation, check here . . . . ▶ ☐

c If you checked the box in **1b** above, check the box(es) for which you wish the organization to be considered.

☐ 4945(g)(1) ☐ 4945(g)(2) ☐ 4945(g)(3)

2 What limitations or restrictions are there on the class of individuals who are eligible recipients? Specifically explain whether there are, or will be, any restrictions or limitations in the selection procedures based upon race or the employment status of the prospective recipient or any relative of the prospective recipient. Also indicate the approximate number of eligible individuals.

3 Indicate the number of grants the organization anticipates making annually . . . . ▶

4 If the organization bases its selections in any way on the employment status of the applicant or any relative of the applicant, indicate whether there is or has been any direct or indirect relationship between the members of the selection committee and the employer. Also indicate whether relatives of the members of the selection committee are possible recipients or have been recipients.

5 Describe any procedures the organization has for supervising grants (such as obtaining reports or transcripts) that it awards and any procedures it has for taking action if the terms of the grant are violated.

For more information, see back of Schedule H.

Additional Information

Private foundations that make grants to individuals for travel, study, or other similar purposes are required to obtain advance approval of their grant procedures from the IRS. Such grants that are awarded under selection procedures that have not been approved by the IRS are subject to a 10% excise tax under section 4945. (See Regulations sections 53.4945-4(c) and (d).)

If you are requesting advance approval of the organization's grant procedures, the following sections apply to line **1c:**

4945(g)(1)— The grant constitutes a scholarship or fellowship grant that meets the provisions of section 117(a) prior to its amendment by the Tax Reform Act of 1986 and is to be used for study at an educational organization (school) described in section 170(b)(1)(A)(ii).

4945(g)(2)— The grant constitutes a prize or award that is subject to the provisions of section 74(b), if the recipient of such a prize or award is selected from the general public.

4945(g)(3)— The purpose of the grant is to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee.

Form 1023 (Rev. 9-98) Page **29**

Schedule I. Successors to "For Profit" Institutions

1 What was the name of the predecessor organization and the nature of its activities?

2 Who were the owners or principal stockholders of the predecessor organization? (If more space is needed, attach schedule.)

Name and address	Share or interest

3 Describe the business or family relationship between the owners or principal stockholders and principal employees of the predecessor organization and the officers, directors, and principal employees of the applicant organization.

4a Attach a copy of the agreement of sale or other contract that sets forth the terms and conditions of sale of the predecessor organization or of its assets to the applicant organization.

b Attach an appraisal by an independent qualified expert showing the fair market value at the time of sale of the facilities or property interest sold.

5 Has any property or equipment formerly used by the predecessor organization been rented to the applicant organization or will any such property be rented? . . . . ☐ **Yes** ☐ **No**
If "Yes," explain and attach copies of all leases and contracts.

6 Is the organization leasing or will it lease or otherwise make available any space or equipment to the owners, principal stockholders, or principal employees of the predecessor organization? . . . . . . ☐ **Yes** ☐ **No**
If "Yes," explain and attach a list of these tenants and a copy of the lease for each such tenant.

7 Were any new operating policies initiated as a result of the transfer of assets from a profit-making organization to a nonprofit organization? . . . . ☐ **Yes** ☐ **No**
If "Yes," explain.

Additional Information

A "for profit" institution for purposes of Schedule I includes any organization in which a person may have a proprietary or partnership interest, hold corporate stock, or otherwise exercise an ownership interest. The institution need not have operated for the purpose of making a profit.

Form **SS-4**
(Rev. February 1998)
Department of the Treasury
Internal Revenue Service

Application for Employer Identification Number

(For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, certain individuals, and others. See instructions.)

▶ Keep a copy for your records.

EIN

OMB No. 1545-0003

Please type or print clearly.

1 Name of applicant (legal name) (see instructions)

2 Trade name of business (if different from name on line 1)
3 Executor, trustee, "care of" name

4a Mailing address (street address) (room, apt., or suite no.)
5a Business address (if different from address on lines 4a and 4b)

4b City, state, and ZIP code
5b City, state, and ZIP code

6 County and state where principal business is located

7 Name of principal officer, general partner, grantor, owner, or trustor—SSN or ITIN may be required (see instructions) ▶

8a Type of entity (Check only one box.) (see instructions)
Caution: *If applicant is a limited liability company, see the instructions for line 8a.*

- ☐ Sole proprietor (SSN)
- ☐ Partnership
- ☐ Personal service corp.
- ☐ REMIC
- ☐ National Guard
- ☐ State/local government
- ☐ Farmers' cooperative
- ☐ Church or church-controlled organization
- ☐ Other nonprofit organization (specify) ▶ (enter GEN if applicable)
- ☐ Other (specify) ▶
- ☐ Estate (SSN of decedent)
- ☐ Plan administrator (SSN)
- ☐ Other corporation (specify) ▶
- ☐ Trust
- ☐ Federal government/military

8b If a corporation, name the state or foreign country (if applicable) where incorporated | State | Foreign country

9 Reason for applying (Check only one box.) (see instructions)

- ☐ Started new business (specify type) ▶
- ☐ Hired employees (Check the box and see line 12.)
- ☐ Created a pension plan (specify type) ▶
- ☐ Banking purpose (specify purpose) ▶
- ☐ Changed type of organization (specify new type) ▶
- ☐ Purchased going business
- ☐ Created a trust (specify type) ▶
- ☐ Other (specify) ▶

10 Date business started or acquired (month, day, year) (see instructions)
11 Closing month of accounting year (see instructions)

12 First date wages or annuities were paid or will be paid (month, day, year). **Note:** *If applicant is a withholding agent, enter date income will first be paid to nonresident alien. (month, day, year)* . . . . ▶

13 Highest number of employees expected in the next 12 months. **Note:** *If the applicant does not expect to have any employees during the period, enter -0-. (see instructions)* . . . . . ▶ | Nonagricultural | Agricultural | Household

14 Principal activity (see instructions) ▶

15 Is the principal business activity manufacturing? . . . . ☐ **Yes** ☐ **No**
If "Yes," principal product and raw material used ▶

16 To whom are most of the products or services sold? Please check one box. ☐ Business (wholesale)
☐ Public (retail) ☐ Other (specify) ▶ ☐ N/A

17a Has the applicant ever applied for an employer identification number for this or any other business? . . . . . ☐ **Yes** ☐ **No**
Note: *If "Yes," please complete lines 17b and 17c.*

17b If you checked "Yes" on line 17a, give applicant's legal name and trade name shown on prior application, if different from line 1 or 2 above.
Legal name ▶ Trade name ▶

17c Approximate date when and city and state where the application was filed. Enter previous employer identification number if known.

Approximate date when filed (mo., day, year)	City and state where filed	Previous EIN

Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete.

Business telephone number (include area code)

Fax telephone number (include area code)

Name and title (Please type or print clearly.) ▶

Signature ▶ Date ▶

Note: *Do not write below this line. For official use only.*

Please leave blank ▶	Geo.	Ind.	Class	Size	Reason for applying

For Paperwork Reduction Act Notice, see page 4. Cat. No. 16055N Form **SS-4** (Rev. 2-98)

Form **8718**
(Rev. January 1998)
Department of the Treasury
Internal Revenue Service

User Fee for Exempt Organization Determination Letter Request

▶ **Attach this form to determination letter application.**
(Form 8718 is NOT a determination letter application.)

For IRS Use Only
Control number ______
Amount paid ______
User fee screener ______

1 Name of organization

2 **Employer Identification Number**

Caution: *Do not attach Form 8718 to an application for a pension plan determination letter. Use Form 8717 instead.*

3 **Type of request**	**Fee**
a ☐ Initial request for a determination letter for: • An exempt organization that has had annual gross receipts averaging not more than $10,000 during the preceding 4 years, or • A new organization that anticipates gross receipts averaging not more than $10,000 during its first 4 years ▶	$150

Note: *If you checked box 3a, you must complete the Certification below.*

Certification

I certify that the annual gross receipts of ....
name of organization

have averaged (or are expected to average) not more than $10,000 during the preceding 4 (or the first 4) years of operation.

Signature ▶ Title ▶

b ☐ Initial request for a determination letter for: • An exempt organization that has had annual gross receipts averaging more than $10,000 during the preceding 4 years, or • A new organization that anticipates gross receipts averaging more than $10,000 during its first 4 years .. ▶	$500
c ☐ Group exemption letters . . . . ▶	$500

Instructions

The law requires payment of a user fee with each application for a determination letter. The user fees are listed on line 3 above. For more information, see Rev. Proc. 98-8, 1998-1, I.R.B. 225.

Check the box on line 3 for the type of application you are submitting. If you check box 3a, you must complete and sign the certification statement that appears under line 3a.

Attach to Form 8718 a check or money order payable to the Internal Revenue Service for the full amount of the user fee. If you do not include the full amount, your application will be returned. Attach Form 8718 to your determination letter application.

Send the determination letter application and Form 8718 to:

Internal Revenue Service
P.O. Box 192
Covington, KY 41012-0192

If you are using express mail or a delivery service, send the application and Form 8718 to:

Internal Revenue Service
201 West Rivercenter Blvd.
Attn: Extracting Stop 312
Covington, KY 41011

Attach Check or Money Order Here

Cat. No. 64728Z

Form **8718** (Rev. 1-98)

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