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Structuring Transfers and Trusts to Qualify for Gift and GST Tax Exclusions for Educational and Medical Expenses Under §§ 2503(e); 2611(b); and 2642(c)

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A. Gift Tax Exclusion for Tuition and Medical Expenses

The Code[1] excludes payments for tuition and medical care that are paid directly to the school or medical care provider from the definition of a "gift." As a result, such payments are not subject to the gift tax regardless of their amount.

Specifically, Code Section 2503(e) provides:

(1) IN GENERAL. --Any qualified transfer shall not be treated as a transfer of property by gift for purposes of this chapter.

(2) QUALIFIED TRANSFER. --For purposes of this subsection, the term "qualified transfer" means any amount paid on behalf of an individual --

(A) as tuition to an educational organization described in section 170(b)(1)(A)(ii) for the education or training of such individual, or

(B) to any person who provides medical care (as defined in section 213(d)) with respect to such individual as payment for such medical care.

However, to fall within the exclusion, such amounts must be paid directly to the education or medical care provider; reimbursing a family member or others for such expenses will not qualify.

B. GST Tax Exclusion for Tuition and Medical Expenses

Similarly, Code Sections 2611(b) excludes from the definition of "generation-skipping transfer" gifts that are non-taxable under IRC Section 2503(e). Specifically, Code Section 2611(b) provides, in part:

> The term "generation-skipping transfer" does not include -- (1) any transfer which, if made inter vivos by an individual, would not be treated as a taxable gift by reason of section 2503(e) (relating to exclusion of certain transfers for educational or medical expenses). . .

This is supplemented by Code Section 2642(c), which states that, "In the case of a direct skip which is a nontaxable gift, the inclusion ratio shall be zero." Section 2642(c)(3) defines "nontaxable gift" as "any transfer of property to the extent such transfer is not treated as a taxable gift by reason of -- section 2503(e)."

Thus, tuition and medical payments on behalf of grandchildren that qualify for the Section 2503(e) gift tax exclusion are not subject to generation-skipping transfer (GST) tax. Over the course of a grandchild's life, a grandparent could make significant tax-free gifts on behalf of his or her grandchildren,

[1] All references to the "Code" are to the Internal Revenue Code of 1986, as amended.

benefiting not only the grandchild whose life is enriched by the education received but also the grandchild's parent, who is relieved of these financial costs. This exclusion from the definition of generation-skipping transfer also applies to distributions from trusts that would otherwise be taxable distributions, as defined in Code Section 2612(b).[2]

II. Focus on Exclusion for Tuition Expenses

A. Limited to Tuition Payments

The Section 2503(e) exclusion is limited to payments for tuition. Payments for books, supplies, room and board, and other education-related expenses are not excluded under IRC Section 2503(e). The beneficiary does not need to attend the school on a full-time basis; tuition for a part-time student is also excluded from gift tax under IRC Section 2503(e).

B. Payments Made Directly to Educational Institutions

To qualify for the Section 2503(e) exclusion, a tuition payment must be made directly to the educational institution and not as reimbursements to the student for his or her expenses.

Code Section 2503(e) requires the payments to be paid "as tuition to an educational organization described in section 170(b)(1)(A)(ii)." Code Section 170(b)(1)(A)(ii) refers to "an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." A tax-exempt educational organization (as most are) will have a determination letter stating that it is an organization described in IRC Section 170(b)(1)(A)(ii); however, for purposes of the exclusion, such a determination letter is not required so long as the organization is described in such Code Section.

> *Tip: To determine whether tuition payments will be excluded under Section 2503, one should first ask the school if it has a determination letter from the Service indicating the contributions thereto are deductible under Code Section 170(b)(1)(A)(ii).*

An "educational organization" includes any type and level of school and is not limited to colleges and universities. *The test is applied to the organization providing the education, and not on the type of education provided.* Accordingly, tuition for nursery school, private elementary school, and high school may qualify, as well as tuition at a public or private college, university, or trade school. In addition, based on the definition of "educational organization," tuition for "extracurricular" education, such as karate or ballet school, should also be covered where the primary purpose of the organization is formal instruction.[3]

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[2] See Letter Ruling 9109032 (Nov. 30, 1990): "Under section 2503(e) of the Code, any payment that is made to an educational organization described in section 170(b)(1)(A)(ii) of the Code, as tuition for an individual, is not treated as a gift to the individual. Correspondingly, any distribution from a trust to such an educational organization, in payment of a trust beneficiary's tuition, is not treated as a generation-skipping transfer. Section 2611(b)."

[3] See Rev. Ruls. 67-447, 1967-2 C.B. 121 (ballet school), 78-309, 1978-2 C.B. 123 (martial arts school), Rev. Rul. 79-130, 1979-1 C.B. 332 (yoga school).

All that is required is that the organization “normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.”

It is not the type of class that is determinative, but the organization conducting the class that must qualify. For example, in Revenue Ruling 79-167,[4] the Service held that classes for art, cooking, dance, photography, swimming, languages, gymnastics, and mechanics classes offered by a community center were considered interrelated parts of the organization's social, cultural, and recreational programs rather than the planned curriculum of a school. In contrast, if those classes were held at specialized schools (art school, dance studio, etc.), the tuition likely would have qualified under Section 2503(e).

III. Focus on Exclusion for Medical Expenses

A. General

Code Section 2503(e) excludes from the gift tax any amount paid on behalf of an individual to any person who provides medical care to such individual. The payment must be made directly to the medical care provider and not as a reimbursement to the donee for his or her expenses. The exclusion does not apply to amounts paid for medical care that are reimbursed by the donee's insurance

B. Definition of “Medical Care”

1. General Medical Care

The exclusion only applies to medical care defined in Code Section 213(d). Section 213(d)(1) defines term "medical care" as amounts paid --

> (A) for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body,
>
> (B) for transportation primarily for and essential to medical care referred to in subparagraph (A),
>
> (C) for qualified long-term care services (as defined in section 7702B(c)), or
>
> (D) for insurance (including amounts paid as premiums under part B of title XVIII of the Social Security Act, relating to supplementary medical insurance for the aged) covering medical care referred to in subparagraphs (A) and (B) or for any qualified long-term care insurance contract (as defined in section 7702B(b)).

The definition of "medical care" is somewhat elusive. The general rule is that there must be a direct or proximate relationship between the expense and the treatment of a specific medical condition (i.e., the prevention or alleviation of a physical or mental defect or illness). The Tax Court has held that there are several factors to consider in determining whether a medical expense is deductible under Section 213(d), including:

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[4] 1979-1 C.B. 335.

- the motive or purpose of the taxpayer
- the origin of the expense
- whether a physician directed or suggested the treatment
- whether the treatment was directly related to the physical condition in question
- whether the treatment was likely to be effective
- whether the treatment was given soon after the onset or recurrence of the disease or condition.[5]

Generally, the medical care exception will include amounts paid for psychiatric treatment; in-home health care; transportation essential to medical care; medical insurance on behalf of an individual;[6] and qualified long-term care services.

2. Certain Lodging Expenses

Code Section 213(d)(2) treats certain amounts paid for lodging away from home as medical care expenses, thereby excluding them from tax under Section 2503(e). Specifically, Section 213(d)(2) provides:

> Amounts paid for lodging (not lavish or extravagant under the circumstances) while away from home primarily for and essential to medical care referred to in paragraph (1)(A) shall be treated as amounts paid for medical care if --
>
> (A) the medical care referred to in paragraph (1)(A) is provided by a physician in a licensed hospital (or in a medical care facility which is related to, or the equivalent of, a licensed hospital), and
>
> (B) there is no significant element of personal pleasure, recreation, or vacation in the travel away from home.
>
> The amount taken into account under the preceding sentence shall not exceed $50 for each night for each individual.

Unlike other expenses for medical care, the lodging expenses associated with medical care fall within Section 213(d)(2) only if the care is provided by a physician in a licensed hospital or associated facility. As explained below, payments for other medical expenses are not required to be for services provided by a physician to be excluded from gift tax.

3. Prescription Drugs

Section 213(d)(3) includes payments for "prescribed drugs" within the definition of medical care. The term "prescribed drug" is defined as a drug or biological which requires a prescription of a physician for its use by an individual. Drugs purchased "over the counter" do not fall within this definition.

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5 See *Havey v. Comm'r*, 12 T.C. 409, 412 (1949).

6 Treas. Reg. §25.2503-6(b)(3).

4. Cosmetic Surgery

Code Section 213(d)(9) was added in 1990 to exclude many forms of cosmetic surgery. It provides:

> (A) IN GENERAL. --The term "medical care" does not include cosmetic surgery or other similar procedures, unless the surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease.
>
> (B) COSMETIC SURGERY DEFINED. --For purposes of this paragraph, the term "cosmetic surgery" means any procedure which is directed at improving the patient's appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease.

Prior to Section 213(d)'s enactment, Revenue Ruling 82-111[7] held that electrolysis-- a procedure typically directed at improving one's appearance-- came within 213(d).

5. Non-Medical Personnel or Treatment

Unlike the exclusion for tuition, which is dependent on the nature of the educational provider rather than the type of education provided, the medical care exclusion focuses on the nature of the services rendered, rather than the qualifications of the person rendering them.

Therefore, a licensed practitioner is not required to provide nursing services in order to qualify for a deduction under Section 213.[8] Conversely, employing a licensed physician or nurse rather than a lay person does not ensure that the services will be deductible as medical care. As a result, services provided by chiropractors, psychologists, Christian Science practitioners, and other persons not licensed to practice medicine or nursing may be considered as medical care.[9]

6. Expenses For Preserving General Health

The regulations promulgated under Section 213 limit the deduction for medical care "strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness."[10] To qualify for a deduction, the practitioner's services must be directed at a physical or mental disability,

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[7] 1982-1 CB 48, (Jan. 1, 1982).

[8] See Rev. Rul. 75-317, 1975-2 C.B. 57.

[9] Rev. Rul. 82-111, 1982-1 C.B. 48 (electrolysis by licensed technician qualified under Section 213-- pre-1990); Rev. Rul. 72-593, 1972-2 C.B. 180 (acupuncture); Rev. Rul. 63-91, 1963-1 C.B. 54 (chiropractors and psychotherapists; services can qualify even if practitioner is not required to be licensed or, despite such requirement, is not licensed); Rev. Rul. 55-261, 1955-1 C.B. 307 (Christian Science practitioners).

[10] Reg. §1.213-1(e)(1)(ii).

not to the taxpayer's general well-being.[11] Expenses that are merely beneficial to the general health of an individual are not deductible as medical care.[12]

For example, the costs of exercise equipment and membership in health clubs are not deductible, unless particular exercise equipment was prescribed for the treatment of a specific medical condition. Even if the taxpayer has a legitimate medical condition, expenses serving both medical and personal objectives are not deductible if the medical benefit is secondary or remote, if the expenses would have been incurred even in the absence of the medical condition, or if the mode of achieving the medical benefit is unnecessarily expensive.[13]

7. Domestic Services

Nursing services are deductible under Section 213, even if rendered in the patient's residence, but the cost of domestic or housekeeping services (i.e., non-nurses who are not performing nursing services) is a nondeductible living expense, even if incurred only because illness makes it impossible for the patient

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[11] See Wendell v. Comm'r, 12 T.C. 161 (1949) (cost of practical nurse caring for healthy infant whose mother died in childbirth not deductible); Tautolo v. Comm'r, 34 T.C.M. (CCH) 1198 (1975) (treatment by native Samoan healers nondeductible because not oriented specifically toward patient's illness); Brown v. Comm'r, 62 T.C. 551, 554 (1974) (Scientology audits not medical care because directed to "general physical, mental, or spiritual well-being," not particular medical condition); Rev. Rul. 75-187, 1975-1 C.B. 92 (treatment for sexual inadequacy is deductible); Rev. Rul. 75-319, 1975-2 C.B. 88 (marriage counseling is not deductible); Bordas v. Comm'r, 29 T.C.M. (CCH) 458 (1970) (driving automobile prescribed as therapy for person injured in serious accident; operating expenses, but not cost of car, deductible); Rev. Rul. 62-210, 1962-2 C.B. 89 (clarinet lessons to remedy child's malocclusion deductible); Adler v. Comm'r, 330 F.2d 91 (9th Cir. 1964) (self-prescribed dancing lessons for varicose veins nondeductible); Thoene v. Comm'r, 33 T.C. 62 (1959) (dancing recommended by physician nondeductible); Rabb v. Comm'r, 31 T.C.M. (CCH) 476 (1972) (expensive shopping trips as "milieu therapy" nondeductible); Rev. Rul. 55-261, 1955-1 C.B. 307 (no deduction for wigs); but see Rev. Rul. 62-189, 1962-2 C.B. 88 (wig deductible where recommended by physician for mental health of child who lost hair from disease).

[12] See Gerstacker v. Comm'r, 414 F.2d 448, 450 (6th Cir., 1969); Haines v. Comm'r, 71 T.C. 644, 646 (1979).

[13] See France v. Comm'r, 40 T.C.M. (CCH) 508 (1980), aff'd per curiam, 690 F.2d 68 (6th Cir., 1982) (no deduction for dance lessons of arthritic individual even though recommended by physician); Ende v. Comm'r, 34 T.C.M. (CCH) 1096 (1975) (child with curvature of spine: expense of attending ballet school not deductible in absence of evidence she would not have taken ballet lessons without ailment); Jacobs v. Comm'r, 62 T.C. 813, 819 (1974) (expenses of divorce not deductible even though recommended by psychiatrist because of marriage's adverse impact on taxpayer's mental health); Rodgers v. Comm'r, 25 T.C. 254, 261 (1955), aff'd, 241 F.2d 552 (8th Cir. 1957) (taxpayer with arteriosclerosis not allowed to deduct cost of going south in winter: "choice of this migratory life over permanent settlement in a salubrious climate was apparently motivated entirely by personal considerations"); Havey v. Comm'r, 12 T.C. 409 (1949) (improved climate no more beneficial to heart patient than to other vacationers); Huff v. Comm'r, 69 T.C.M. (CCH) 2551, 2555 (1995) (no deduction for panchakarma treatment of diet, massage, and baths at the Maharishi Ayur-Veda Health Center under supervision of Drs. Rothenberg and Chopra, additional massage on recommendation of "homeopathic acupuncture physician," yoga lessons, gym fees, hot tub installation, home water filtration system on recommendation of colonic irrigationist, vitamins, and food supplements; in contrast, deduction was allowed for acupuncture, chiropractic consultations, and colon hydro-therapy prescribed by homeopathic acupuncture physician).

to perform the services. Thus, domestic services are not deductible if the employee is hired not to render services to the patient but to take the patient's place in looking after other members of the household.[14]

IV. Structuring Transfers and Trusts to Maximize Use of the Exclusions

A. Trust Distributions for Tuition and Medical Care

One way to maximize use of the tuition and medical care exceptions is to include provisions in trusts allowing distributions for tuition and health expenses. These could be in the form of powers of appointment held by the beneficiary, who could direct the trustee to pay for his children's tuition and medical care expenses. Such exercises would not result in a gift by the beneficiary by reason of Section 2503(e). Such payments could be made on behalf of "skip persons" (*e.g.*, descendants of the beneficiary) without triggering GST tax-- even if the trust is not GST exempt. The provisions could either prohibit distributions that would trigger GST tax, or merely request the trustee to consider the tax consequences of making distributions.

B. Prepaid Tuition Agreements

The Service has held in a Technical Advice Memorandum and a private letter ruling that an agreement with a school to prepay future tuition expenses is excluded from gift tax so long as the payment relates to tuition and not to expenses outside the scope of Section 2503(e).

In TAM 199941013,[15] the taxpayers (grandparents) made payments to a private school providing classes from preschool through grade 12 to cover the tuition of their two grandchildren attending the school. At the time of the payments, the grandparents entered into written agreements with the school. Under the agreements, the payments were to be applied in payment of tuition for the grandchildren for specified years and were not refundable. If the grandchildren ceased to attend the school, then the school would retain the funds. Further, the grandparents and the grandchildren's father agreed that if the cost of tuition at the school increased with respect to any year, then the school would be paid the additional funds necessary to cover the increased tuition.

The Service concluded that the payments were made directly to an educational organization to be used exclusively for the payment of specified tuition costs for designated individuals. Accordingly, the payments constituted an "amount paid on behalf of an individual as tuition to an educational organization ... for the education or training of such individual" for purposes of Code Section 2503(e)(2).

Similarly, in Letter Ruling 200602002[16], the taxpayer proposed to enter into a separate written agreement with a private school with respect to each of his six grandchildren. Under each agreement, the

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14 See Borgmann v. Comm'r, 438 F.2d 1211 (9th Cir., 1971) (cooking, cleaning, and other domestic services nondeductible, despite physician's advice to taxpayer with heart condition to hire live-in housekeeper); Ochs v. Comm'r, 195 F.2d 692 (2d Cir., 1952) (no deduction for cost of sending healthy children to boarding school to alleviate burden of wife, who was prevented by illness from caring for them); see also Van Vechten v. Comm'r, 32 T.C.M. (CCH) 1363 (1973), aff'd by unpublished order (3d Cir., 1975); Kohen v. Comm'r, 44 T.C.M. (CCH) 1518 (1982) (no deduction for cost of nurse who assisted in care of healthy baby after normal delivery).

15 July 9, 1999.

16 September 6, 2005.

taxpayer agreed to prepay the total annual tuition for the grandchild for each grade level through graduation in grade 12. In each agreement, the taxpayer acknowledges that tuition may increase in subsequent years and agreed that the balance due after the application of the prepayment for that year will paid by the taxpayer, or the parents of the respective grandchild (who would a sign a consent and joinder). The tuition payments are non-refundable. Finally, the prepayment does not afford the respective grandchild any additional rights or privileges over any other student, does not guarantee enrollment, and the school expressly reserves all rights under its standards policies and procedures. The Service ruled that the taxpayer's prepayment of tuition for his grandchildren are "qualified transfers" excluded from the gift tax under Section 2503(e) and are not generation-skipping transfers under IRC Section 2611(b)(1).

Such agreements can have significant tax benefits: gift- and estate-tax free transfers totaling hundreds of thousands (or even millions) of dollars, depending on the number of children, grandchildren and great-grandchildren involved and the amount of tuition at the education institutions. Of course, they have their risks as well. Perhaps prepaying tuition will help the intended beneficiaries get accepted at the school in the first place-- a little money never hurt anyone's chances.

The biggest risk is that the intended beneficiaries do not attend or remain at the school for one reason or another. This can occur because they are not accepted at the school, they don't live in the geographical area of the school or subsequently move away, or they simply choose to attend another school.

If one enters into a prepaid tuition agreement, be sure to include the following terms:

- the payments should be non-refundable, as in the TAM and PLR
- the payment should cover only tuition
- include provisions regarding future tuition increases - at least acknowledge it may increase and that someone will pay the difference
- permit the payments to cover tuition more than one family member that may attend the school
- consider directing that unused funds are added to a scholarship fund- although no charitable deduction will be allowed

Finally, note that most state-run prepaid tuition plans will not qualify for the 2503(e) exclusion because the amounts are not paid to an educational organization, but rather to a state fund that will be used to pay future tuition expenses.

C. Health and Education Exclusion Trusts (HEET Trusts)

To take the benefits of IRC Section 2503(e) one step further, it is necessary to take a closer look at the GST aspects of the health and tuition exclusions. As explained above, Code Section 2611(b) excludes from the definition of "generation-skipping transfer" any transfer that, "if made inter vivos by an individual, would not be treated as a taxable gift by reason of section 2503(e)." Accordingly, a distribution from a non-GST exempt trust to pay the tuition or qualified health care expenses of a skip person would not be a generation skipping transfer because, if such payment were made by an individual during his lifetime, it would not be treated as a taxable gift under Section 2503(e).[17]

Therefore, one could create a trust that pays the tuition and medical care expenses of children, grandchildren, great-grandchildren, and more remote descendants without allocating GST exemption to the trust, and such payments will not be subject to GST tax. We call such a trust a "health and education exclusion trust," or “HEET.”[18]

Such a trust can provide several financial benefits, including the following:

- segregates (and thereby protects) funds to be used to cover future health and tuition expenses, ensuring such expenses will be provided for even other funds are spent
- permits the beneficiaries’ (and their parents’) other assets to be used for other purposes
- avoids consuming GST exempt property on tuition and health care expenses, preserving such property for other financial needs of the beneficiaries

1. Structure and GST Analysis of the HEET

A HEET is established by executing and funding a trust in which the trustee is authorized or directly to pay for the tuition and medical care of children, grandchildren, great-grandchildren, and so on. The trust could last in perpetuity until the trust property is consumed or the Rule Against Perpetuities causes the trust to terminate. GST exemption would not be allocated to the trust.

However, when the last current beneficiary of the trust who is not a skip person dies, the trust itself becomes a skip person and a taxable termination would occur.[19] Thus, the trick is to prevent the taxable termination by including a charity as a beneficiary of the HEET. In such case, there will always be at least one beneficiary (the charity) that is not a skip person. As a result, the trust itself will not become a skip person and a taxable termination will never occur.

The trust can designate one or more specific charities as beneficiaries or can authorize the trustee to select the charities each year. However, if the grantor's private foundation is designated as the charitable beneficiary during the grantor's life, the funds distributed to the foundation should be segregated and the foundation's bylaws amended so that the grantor cannot participate in decisions regarding the use of such funds. Otherwise, the property distributed from the trust to the foundation could be included in the grantor's gross estate under Section 2036(a).[20]

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17 See Ltr. Rul. 9823006 (June 5, 1998).

18 See David A. Handler, Deborah V. Dunn and Roy M. Adams, "The HEET Trust: A New Twist on Section 2503(e)," Trusts & Estates (July 2000); Michael N. Delgass and Deborah S. Gordon, "HEET Wave," Trusts & Estates (March 2005).

19 See IRC §§ 2613(a), 2612(a).

20 See Rifkind v. United States, 5 Ct. Cl. 362 (1984).

Section 2652(c)(2) contains a pitfall for the HEET. It provides that an interest in a trust will be disregarded if it is used primarily to postpone or avoid GST tax. Therefore, the charity's interest in the HEET should be significant and indicative of true charitable intent. The trust should thus provide for mandatory annual distributions to charity in some form, such as a percentage of the annual income realized by the trust.

While such a floor may avoid the application of the anti-abuse rule, it may inadvertently create other problems. Regulations promulgated under Chapter 13 import the concept of "substantially separate and independent shares" from the regulations under Code Section 663, and treat a trust having such separate shares for different beneficiaries as separate trusts for each beneficiary.[21] For example, consider a HEET for the benefit of grandchildren that provides that a charitable beneficiary will receive 10 percent of the trust income each year, and 10 percent of each principal distribution. The separate share rules could be applied to treat the HEET as two trusts: one trust for the benefit of the charity (a 10 percent share), and a second trust for the benefit of the grandchildren (a 90 percent share). As a result, 90% of the initial transfer to the HEET might be treated as a direct skip to the second trust because it would have only skip person beneficiaries. If children are included as beneficiaries, a taxable termination could eventually occur when the last child dies (again, because one trust would have no non-skip beneficiaries).

This problem can be avoided in one of two ways. First, to be treated as a separate share, that share must exist "from and at all times after the creation of trust."[22] Thus, if the HEETs charitable beneficiary had an indefinite right to income and principal initially (perhaps while there are other non-skip beneficiaries to the HEET, such as the grantor's children), and then acquired its fixed rights to income and principal at a later date (at the death of the survivor of the grantor's children, for example), no separate share would have been created.[23]

Second, the HEET could be drafted such that charitable beneficiary's interest remains indefinite throughout the trust's life by allowing the trustee may make entirely discretionary payments of income and principal, in addition to some fixed amount of income to ensure that the charitable interest is treated as current and substantial. The uncertainty as to what the charity ultimately will receive should avoid the creation of a separate share that excludes the charity as a beneficiary.[24]

Although the charity need not become a beneficiary of the trust until the last surviving non-skip person dies in order to prevent the HEET from becoming a skip person, in order to avoid any argument that the provisions of Section 2652(c)(2) apply, charity should be included as a beneficiary from the trust's inception.

2. Funding the HEET

While distributions from the HEET for tuition and qualified health care expenses are not subject to gift or GST tax, contributions to the HEET do not qualify for the Section 2503(e) exclusion because

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21 Reg. Section 26.2654-1(a)(1)(i).

22 Reg. Section 26.2654-1(a)(1)(i).

23 Reg. Section 26.2654-1(a)(5), Ex. 8.

24 Reg. Section 26.2654-1(a)(5), Ex. 2.

they are not payments to an educational institution or to a person who provides medical care. Therefore, the "usual" methods of transferring assets to a trust need to be employed, such as annual exclusion gifts or gifts using one's gift tax exemption. Because children, grandchildren, and great-grandchildren all could be beneficiaries of the trust, Crummey withdrawal rights could be granted to all of them without being subject to attack by the Service for "abusive" use of such rights.[25] GRATs and other strategies could also be used to fund a HEET.

Perhaps the most logical way to fund a HEET is via testamentary transfers because one can pay the tuition and medical expenses directly while living. Thus, there is no need for a HEET until the intended grantor dies. If one leaves a stated amount to a HEET under one's will or revocable trust, the estate tax will be no greater than if those funds were left to or in other trusts for the children. In effect, there is no tax cost to leaving assets to a HEET compared to leaving the assets to any other non-charitable recipient. Alternatively, an irrevocable life insurance trust could be structured as a HEET, thereby avoiding estate tax.

3. Income Taxation

If created during the grantor's life, a HEET often will be structured as a "grantor trust" so that all items of income, deduction and credit are reported and payable by the grantor. If so, the grantor will receive an income tax deduction for amounts distributed by the HEET to a charitable entity that would have qualified for a charitable deduction if made directly by the grantor.

Obviously when the trust is taxed as a complex trust (*e.g.*, after the grantor's death), it will file its own federal Form 1041.[26] Distributions of income to the charitable beneficiary will give rise to a charitable income tax deduction under Code Section 642(c).

4. Private Foundation Rules

Because Section 642(c) permits a deduction to the trust upon making a distribution to a charitable beneficiary, it might appear that the HEET could be subject to the stringent self-dealing rules. Code Section 4941 imposes a tax on each act of self-dealing between a "disqualified person" and a private foundation. Section 4947 applies this provision to any trust that is (1) not exempt from tax under Code Section 501(a), (2) as to which some of the interests are not charitable, and (3) for which a deduction was allowed under Section 642(c). At first glance, it appears that a HEET should be subject to the self-dealing rules because a HEET is not exempt under Section 501(a), some of the interests are not charitable, and one of a HEETs goals is to allow a deduction for the charitable distribution under IRC Section 642(c). However, Section 4947(a)(2)(A) states that the self-dealing rules do not apply to amounts payable to income beneficiaries of such a split-interest trust "unless a deduction was allowed under section 170(f)(a)(B), 2055(e)(2)(B), or 2522(c)(2)(B)." And, because no deduction is allowed under these sections in the case of a HEET, the self-dealing rules do not apply to distributions to income beneficiaries.

[25] See Cristofani v. Comm'r, 97 T.C. 74 (1991); TAM 9731004 (Aug. 1, 1997).

[26] The state in which the trust files its state return may depend on several factors, including the state of residence of the grantor, the beneficiaries and the trustees.

In short, a HEET should not be subject to the private foundation rules merely because it permits or requires a portion of its income and principal to be distributed to a charity as long as not all of the beneficiaries of the trust are charities.