PRIVATE MEDICAL RESEARCH FOUNDATION
(Generic name: Medical Research Organization)

A Summary by Marvin Goodson*

A private medical research foundation ("PMRF") is a *special* kind of private foundation. It does not have *any* private foundation restrictions. It can keep controlling ownership of a company without limit. The founder can place anyone he wants on the board to control the PMRF and control the founder's company, during the founder's life and after his death.

There is no excise tax, no income tax, and no capital gains tax! There is no 5% annual distribution requirement.

What Must It Do? --- Only two things.

1. Each year it must expend 3.5% of its endowment in the *direct, active conduct of medical research through its own staff* --- which can be part-time or full-time employees; and

2. Do its research *"in conjunction" with a non-profit hospital.* "In conjunction" means there must be some cooperative relationship with a hospital. The hospital does not have to have a seat on the board. This only requires a very loose association between the hospital and the PMRF.

What Else Can the PMRF Do?

So long as it meets the 3.5% test, it can also make distributions each year of up to 2.5% of its endowment for *any charitable purpose*.

Is there any other way to get these same results, or even somewhere near these same results? Answer: NO! There is *no* other way a major stockholder of a company can:

1. Contribute appreciated stock to a private foundation during his life and get an income tax deduction for the fair market value of the stock;

2. Have the company buy the stock from the private foundation;

3. Keep control of his company, in his family or in his executives after his death; and

4. Totally avoid estate taxes on the value of his stock holdings.

A private foundation cannot do it.

An operating foundation cannot do it.

Only a private medical research foundation can do it.

The attached chart compares a PMRF with a private foundation.

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* This is a summary of a long article by Marvin Goodson that explains in technical detail the operation of a Medical Research Organization to qualify under the Internal Revenue Code as a Private Medical Research Foundation.

COMPARISON CHART

Subject	Regular Private Foundation	Private Medical Research Foundation
Restrictions on owning all or part of a company	Strong restrictions. If family controls company then foundation can have no more than 2% of the stock. In no event can private foundation own control of a company.	No restriction of any kind. PMRF can own 100% of a company.
Taxes on ordinary income and capital gains	2% annual tax.	No tax.
Penalties on failure to distribute income	Yes - Severe penalties if annual, minimum distributions of 5% not made. Tested year by year.	No penalty tax. The requirement for annual 3.5% medical research expenditures can be averaged over several years and is not necessarily tested on a year by year basis.
Deductions for contributions of appreciated capital gain property	Not deductible unless the private foundation makes almost immediate distributions of 100% of contributions.	Fully deductible. Generally, the same as contributions to a public charity with some variations.
Restrictions on dealing with the foundation	Very restricted with severe penalties for violations.	No restrictions.
Restrictions on investments which jeopardize charitable purposes	Strong restrictions and severe penalties.	No restrictions.
Restrictions on taxable expenditures	Severe restrictions and penalties.	No restrictions.

TAX MANAGEMENT ESTATES, GIFTS AND TRUSTS JOURNAL

Vol. 20, No. 2 March-April March 9, 1995

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Tax Management Estates, Gifts and Trusts Journal (ISSN 0886-3547) is published bi-monthly, by Tax Management Inc., 1231 25th Street, N.W., Washington D.C. 20037. The subscription rate is $214 per year for an initial subscription. Second Class postage paid at Washington, D.C. and additional mailing offices. POSTMASTER: Send address changes to Tax Management Estates, Gifts and Trusts Journal, The Bureau of National Affairs, Inc., P.O. Box 40949, Washington, D.C. 20016-0949.

ARTICLES

Private Medical Research Organizations: Long-Term Research Funding Source for Non-Profit Hospitals

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INTRODUCTION

A seldom-referenced provision of the Internal Revenue Code, giving special tax status to an entity that qualifies as a Medical Research Organization (MRO), represents an open door for non-profit hospitals to fund their research programs on a long-term, continuing basis.

Non-profit hospitals fund their research from private contributions, grants from private and public foundations, grants from corporations, and special government grants from the National Institutes of Health (NIH) and other government sources. Most of these research grants and programs are limited in time and scope. They also usually require major, ongoing hospital staff involvement at the highest executive level directly with the funding sources to woo, coax, plead, implore, nurse, and massage to obtain funds for research projects — in continual competition with other hospitals, research institutions, and medical schools with similar needs and goals.

Most hospitals and tax practitioners have overlooked the opportunities for major continuing research funding sources provided by a seldom-used provision of the Internal Revenue Code. That provision is contained in the last five lines of §170(b)(1)(A)(iii),[1] which create the MRO, a hybrid, non-profit entity.

Basically, an MRO is a non-profit organization that is engaged in the continuous active conduct of medical research *in conjunction with* a non-profit or government hospital.

A privately controlled MRO has many of the advantages of a public charity and very few of the restrictions of a private foundation. (See Chart, below comparing an MRO with a private foundation.) It also has several features and restrictions unique to an MRO. Guided and managed carefully to follow the law and regulations, a privately funded and controlled MRO has almost none of the draconian booby traps awaiting a private foundation, and most of the freedoms of a public charity.

An MRO may also receive contributions from the public. A well-run MRO will often receive special program grants from government sources such as the NIH.

An MRO provides a hospital, directly and indirectly, with a continuing source of research funds for projects conducted by the MRO "in conjunction" with the hospital. The hospital must be a non-profit or government hospital. The MRO/hospital relationship can be structured as an ongoing loose association — with the MRO being directly engaged in the continuous active conduct of medical research in conjunction with their associated hospital.

The MRO and the hospital should establish guidelines for their respective input into selecting research projects. Research programs and publicity can identify the source as "The ABC Medical Research Institute at XYZ Medical Center." Financial benefits can be derived by allocating income from the transfer of intellectual property between the hospital and the MRO, with the income-sharing ratio depending on the relative financial contributions to its development.

The hospital may commit to provide space, laboratory facilities, computer interfacing, and personnel and to other joint efforts. There are no fixed or preset agreement standards in structuring the MRO hospital

* The author is grateful for the help of Laura K. Farrand, Esq. and Luis C. De Castro, Esq. in the preparation of this article.

[1] "... or if the organization is a medical research organization directly engaged in the continuous active conduct of medical research in conjunction with a hospital, and during the calendar year in which the contribution is made such organization is committed to spend such contributions for such research before January 1 of the fifth calendar year which begins after the date such contribution is made." All section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, unless otherwise indicated.

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relationship. It is all subject to agreement between the hospital and the MRO.

To assist in an understanding of MROs, this article discusses: technical requirements for an MRO; why hospitals have not sought or encouraged MRO associations, and why they should; research "in conjunction" with a hospital; MRO control of an active business — public or private; how wealthy individuals can fund an MRO during life and at death; how an MRO compares with a private foundation; life insurance "wealth replacement" to protect the founder's family and save estate taxes; and converting a private foundation to an MRO.

TECHNICAL REQUIREMENTS FOR AN MRO

An MRO is a medical research organization which: (1) is expressly organized for the purpose of conducting medical research; and (2) is engaged primarily and directly in the continuous active conduct of medical research in conjunction with a non-profit or government hospital.[2] The MRO must not only have the principal purpose of and be organized for this primary activity, it must also be continuously engaged primarily in the active conduct of medical research.[3] *Each of these requirements are important and must be followed without deviation.*

Organization Test

The organization test is simply a matter of form and can be satisfied by using the right words in the charter document establishing the MRO.

Primary Activity Test

The primary activity test is not simple — it is the most important test and it is a matter of substance and operations in practice.

To satisfy the primary activity test, the MRO must either: (1) devote a substantial part of its assets to medical research programs; or (2) expend a "significant percentage" of its endowment for medical research purposes.[4] The primary activity test is a facts and circumstances test,[5] which is a subjective test and difficult to quantify. However, the regulations set forth two objective safe harbor methods of satifying the primary activity test that simplify and, for all practical purposes, avoid the vagaries and uncertainties of the subjective facts and circumstances test.

One safe harbor test is that an MRO that devotes more than one-half of its assets to the continuous active conduct of medical research will be considered to be devoting a substantial part of its assets to such conduct.[6] A more definitive, easier-to-grasp safe harbor test — and the one which this author recommends in most situations should be the *sole* safe harbor test — is that the MRO expend funds annually in its continuous active conduct of medical research equaling at least 3.5% of the fair market value of its endowment (determined annually) which is invested for income or growth.[7]

In determining how that 3.5% is expended, the MRO excludes any funds which are distributed by the MRO to the hospital, to individuals or other organizations for the conduct of research by the recipient or extended as scholarships or grants.[8] The disbursing of funds to other organizations for the conduct of research by them is not engaging in medical research. The MRO must have its own employees, full or part-time, working under the supervision and direction of the MRO.

Start-up MROs are allowed even greater flexibility. This author obtained a private letter ruling (which is unpublished) in 1983 for a new MRO that allowed the MRO to use hospital employees on a loan-out agreement with the hospital. The loan-out employees were under the control and direction of the MRO, but they were hospital employees that were loaned out to work under the supervision and direction of the MRO in the MRO's described research programs. The MRO paid the hospital for the employees' direct and indirect compensation costs. This arrangement was permitted by the IRS during the MRO's start-up period until the MRO was fully operational and able to engage its own employee research personnel and support staff.

The same employee loan-out arrangement would probably be approved by the IRS for special research projects for which especially qualified technical personnel are difficult to find. However, this approach should only be followed with the prior approval from the Exempt Organizations Branch of the IRS.

Disbursing funds to other research organizations and giving scholarships, grants and special research grants to the hospital, individuals, or other organizations are allowed, provided that the 3.5% test is met first and that the additional disbursements for these other purposes do not interfere with the primary activity of engaging in the continuous active conduct of medical research. For example, if 3.7% of the fair market value of the MRO's endowment fund is expended by the MRO directly in its own continuous active conduct of medical research, distributing another 1% to 2% in grants to other §501(c)(3) organizations or to individuals for grants or fellowships will

[2] §170(b)(1)(A)(iii), Regs. §1.170A-9(c)(2)(ii)(b).
[3] Regs. §1.170A-9(c)(2)(v)(*a*).
[4] *Id.*
[5] *Id.*
[6] Regs. §1.170A-9(c)(2)(v)(*b*).
[7] *Id.*
[8] Regs. §1.170A-9(c)(2)(v)(*c*).

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still leave the MRO with its principal purpose and its primary involvement in the continuous activity of its own medical research, and it will maintain its qualification as a medical research organization.

In making the 3.5% of assets calculation, any property, the use of which is "substantially related" to the exercise or performance of the MRO's medical research activities, will not be treated as part of its endowment for calculating the 3.5% safe harbor expenditure.[9] For example, assume a $40,000,000 endowment with $5,000,000 invested in permanent facilities. The 3.5% is measured as 3.5% of $35,000,000, or $1,225,000. It is this $1,225,000 that must be expended annually in the continuous active conduct of research to meet the safe harbor test.[10]

Meaning of Medical Research

Medical research is very broadly defined in the regulations [11] and it would be difficult to conceive of research that would be done in conjunction with a hospital which did not fit under this very liberal definition. The research must be continuous, active, and conducted by and be under the supervision of the MRO. The MRO must have continuously available for its regular use the appropriate equipment and professional employee personnel necessary to carry out its principal function.[12] This cannot be done by subcontracting projects to other organizations, hospitals, or laboratories.[13] Merely having employees is not sufficient.[14] The employees must be under the *control and supervision* of officers of the MRO and must be *directly* engaged in medical research.[15]

Costs Included in 3.5% Test

All costs of operating the MRO, including normal administrative and operating overhead, as well as the salaries of research employees, are included within the 3.5% expenditure test. This author obtained an unpublished PLR that included as expenditures counted in the 3.5% the expenses of employees attending medical conferences for continuing education. Purchases of capital equipment necessary to the conduct of the medical research are considered medical research expenditures.[16] The MRO may also use the hospital's equipment and facilities and may do joint research with hospital personnel. The hospital can provide its own research personnel at its own expense to participate in the MRO's research projects.

[9] Regs. §1.170A-9(c)(2)(vi)(*b*).
[10] *Id.*
[11] Regs. §1.170A-9(c)(2)(iii).
[12] *Id.*
[13] Regs. §1.170A-9(c)(2)(v)(*c*).
[14] GCM 37537 (1978); Regs. §1.170A-9(c)(2)(iii).
[15] GCM 37537 (1978).
[16] Regs. §1.170A-9(c)(2)(viii).

Long-Term Projects

The regulations recognize that medical research programs are sometimes multiyear programs, with long-term planning requirements. Measuring the expenditures for the 3.5% can be done over an extended period of time with fewer funds being expended in the initial year of a long-term research project and more than the 3.5% being expended in the later years of the program, or vice versa. So long as the 3.5% minimum is met by an examination of the whole project on a multiyear basis, the test is met.[17] For complex, multiyear research projects, an advance ruling should be obtained from the IRS which approves the research program expenditure projections as meeting the safe harbor rules. In this regard, the regulations recognize that medical research cannot always be planned, categorized, and budgeted so that expenditures will use the available funds in each and every year.[18]

A start-up MRO is allowed a maximum of three years following its organization to implement its proposed plans to become fully active as an MRO.[19] The proposed initial medical research program, including a fully detailed plan and budget, equivalent to a business plan, should be submitted to the IRS for advance approval of the start-up program.[20]

The regulations are clear and straight-forward. When there is any question, an advance ruling should be sought to clarify the matter. This author has found the IRS to be reasonable and cooperative in this area. With the anticipated shortage of medical research funds in the new health programs being proposed in Washington, this attitude should continue. MROs believe they operate more efficiently — and with more dollars being spent on actual research and less being spent on administration — than with government-controlled, and even with hospital- or medical institution-administered, research projects.

WHY MORE HOSPITALS HAVE NOT SOUGHT OR ENCOURAGED MRO ASSOCIATIONS . . . AND WHY THEY SHOULD

It is the author's experience that many hospitals, historically, have emphasized their "territorial imperative" over research projects. Like government bureaucracies or departments of large (and even small) corporations, some hospital managements often feel they must be in complete control of personnel, operations, and budgets. Any sharing of activities that are not under management's control and domination

[17] Regs. §1.170A-9(c)(2)(vi)(*a*); Regs. §1.170A-9(c)(2)(v)(*a*)(*3*), (*4*).
[18] *Id.*
[19] Regs. §1.170A-9(c)(2)(ix).
[20] *Id.*

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may appear as a threat that will dilute management's strength, vitality, growth, and independence. Many hospital institutions, especially those hospitals that are part of a university or medical school, allocate a substantial overhead charge to all research activities funded by research grants. This is often as high as 40% of all expenditures. This is a toll charge which is not an acceptable MRO expenditure. So, rather than adjust to the changes in approach and attitude necessary to have an MRO do research in conjunction with the hospital, some hospitals — when offered the opportunity — have declined. Very few hospitals have actively sought to initiate an MRO relationship.

The following are some of the hospitals that have recognized the value of an MRO hospital relationship and have established successful, mutually satisfactory relationships with privately funded MROs: Massachusetts General Hospital, San Francisco General Hospital, City of Hope, Kansas University Medical Center, Christ Hospital.

A thorough, objective analysis by a hospital of what the MRO association will mean to the hospital's research programs should lead the hospital board to seek out wealthy individuals or families to establish MROs to enter into research relationships with their hospital. Hospitals often have a large number of long-range research projects they want to have funded. Most grants are inherently short-term. Because an MRO must expend money each and every year in research projects, their research projects are usually long-term. Even if the research projects are short-term, each MRO research project must be followed by a new research project. This feature alone should make the MRO relationship of special interest to hospitals.

To keep a research grant on a continuing or repetitive basis usually requires continuing submissions to the granting source, and, usually, some indication of substantial progress towards success in meeting the goals. On many occasions, the budgeting requirements of the funding source are cut back with a related cut back on their funding.

Sometimes the funding source is subject to other pressures, such as from its own trustees, government regulations, administrative log jams, the public perception of what research should have priority, the press in its many forms, or even congressional action. Further, raising funds from the public for research is not a dependable source for long-term research projects. And most research projects are long-term or very long-term.

An MRO hospital relationship has *almost none* of these negative attributes. Once the MRO relationship has been established, the MRO hospital association should continue indefinitely. This does require that the hospital fulfill its promised obligations to the MRO and treat the Board of the MRO and the administrative, technical, and professional staff of the MRO with the same nurturing care that a good business treats its valued customers. The MRO hospital association can be bolstered substantially by a concurrent relationship with a medical school.

Once the relationship is established, the hospital knows the minimum annual amount that will be expended by the MRO on the mutually agreed upon research projects. For example, if an MRO has an endowment fund of $40,000,000, then the MRO's average annual expenditure for medical research must be at least $1,400,000 (3.5% × $40,000,000). This ependiture must be made for every year and for every year into the future. The headaches and problems of administering the MRO activities do not involve the hospital. The hospital administrative staff has fewer matters to concern them. And in today's regulatory and litigious climate, having fewer employees for which the hospital has primary responsibility can be a benefit.

In the agreement with the MRO, the hospital can sometimes have the first use — and possibly in their geographic area the principal use — for a period of time of the treatment modalities developed by the MRO.

The hospital will also, indirectly, have the benefits of intellectual property royalties. As an intellectual property develops value, this value increases the endowment base upon which the minimum required expenditure is calculated, as explained above.

A hospital is not limited to a single MRO relationship. A hospital having contacts with several wealthy individuals who are interested in the social benefits of medical research and who can recognize the tax benefits of an MRO can help establish and work in conjunction with several MROs at the same time. Each MRO must meet the technical requirements for an MRO and supervise its own research projects. Large, complex research projects can often be divided into several simultaneous, parallel, and interrelated divisions, with each MRO having jurisdiction to conduct its own research part of the project. The possibilities for a hospital with several simultaneous MRO relationships are endless — and should be exciting to a hospital with an imaginative and flexible staff and board of directors. Associating members of the faculty of a medical school for many areas of basic research adds even more possibilities and excitement.

For example, one hospital with relationships with five MROs, each with an endowment of $10,000,000, could plan for at least five research projects expending a combined $1,750,000 each and every year for the indefinite future! [21]

[21] The Association of Independent Research Institutes, the leading group in this area, has between 85 and 90 MRO members. Several hospitals have relationships with more than one MRO.

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The founders of the MRO should have a genuine intense interest in the benefits of medical research. This research may be in one specific medical field in which the founders have a special interest, or in many different medical fields. Specific areas of medical research activity do not have to be determined in advance to obtain an IRS determination letter. The MRO can go into many different research areas or it can limit itself to one area, and it can change its direction of research at any time and from time to time.

RESEARCH IN CONJUNCTION WITH A HOSPITAL

The MRO must do its research "in conjunction" with a non-profit or a government hospital.[22] These words "in conjunction" are very broad and the regulations allow this relationship to remain flexible and relatively unrestricted. The association can be with more than one hospital.[23] "In conjunction" does not need a formal, rigid affiliation. This is a cooperative effort — not a partnership. The hospital is not in control of the MRO as it would be of an §509(a)(3) organization. There should, however, be meaningful joint effort on the part of the MRO and the hospital, pursuant to a written understanding, that the two organizations will maintain continuing close cooperation in the MRO's continuous active conduct of medical research.[24]

Some proofs of the relationship can be: (1) if the activities of the MRO are carried on to some substantial extent in space located within or adjacent to the hospital; [25] (2) if the MRO is permitted to utilize the facilities, equipment, case studies, etc., of the hospital on a continuing basis directly in the active conduct of its medical research; (3) substantial evidence of the close cooperation of the members of the staff of the MRO with members of the staff of the associated hospital; [26] (4) the hospital's need for medical research in specific areas in which the MRO conducts research projects . . . followed by the hospital's application of the research results in its own clinical activities; (5) joint publishing of technical articles about the MRO's research; or (6) joint research by the MRO and hospital staffs.

MRO CONTROL OF AN ACTIVE BUSINESS . . . PUBLIC OR PRIVATE

One of the many restrictions on private foundations is the limitation on "excess business holdings" set forth in §4943. Generally, the basic rule is that a private foundation can only own 2% of the stock of a company if the donor and certain related parties own 20% or more of the voting power of the company.[27] This is a great oversimplification of a very complex Code section. This section came into the law in the Tax Reform Act of 1969 (TRA).[28] Before the TRA there were many abuses by private foundations, including the use of private foundations to control companies and the giving of very little to charity. Those abuses were eliminated in the TRA, principally in §§4940-4948. Under §4943, a private foundation that has "excess business holdings" has five years in which to divest itself and bring its holdings down to the allowed level.

The §4943 excess business holding rules do not apply to an MRO. Even if the family members own complete control of a company, there is no limit on the amount of stock the MRO can own. One of the examples in the regulations discusses an MRO that owns 100% of a company.[29] The trade-off that the tax law imposes is that the MRO must conform strictly to all of the technical requirements described above. This author emphasizes that the technical requirements of the Code and regulations for an MRO must be followed strictly, regularly, consistently, and in good faith, *i.e.*, actively and continuously conduct medical research for the good and benefit of society and the public as a whole. The stock held by the MRO must either pay enough dividends to fund the required research expenditures or combine cash contributions, plus dividends, plus stock redemptions, or stock sales by the MRO — to provide the funds for the research.

HOW WEALTHY INDIVIDUALS CAN FUND AN MRO DURING LIFE AND AT DEATH

There are several Code sections allowing income tax deductions to individuals for lifetime contributions to an MRO. There are several different categories of income tax deductions limited to 20%, 30%, and 50% of an individual's adjusted gross income (technically, the individual's "contribution base," which can be slightly different). If a contribution to an MRO is taken as a deduction under the §170(b)(1)(A), 50% of adjusted gross income limit, the MRO must be committed to spend the entire contribution for medical research by the end of the fourth calendar year after the year of the deductible contribution.[30] The

[22] Regs. §1.170A-9(c)(2)(ii)(*b*).
[23] Regs. §1.170A-9(c)(2)(vii).
[24] *Id.*
[25] *Id.*
[26] *Id.*

[27] §4943(c)(2).
[28] P.L. 91-172.
[29] Regs. §1.170A-9(c)(2)(x), Ex. 3.
[30] §170(b)(1)(A)(iii); Regs. §1.170A-9(c)(2)(i); *Robert L. Fox*, 27 T.C.M. 1001.

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MRO's commitment for this purpose must be legally enforceable.[31] This legal commitment can be met by contract between the MRO and the contributors, or by provision in the by-laws or in the charter documents.[32]

This commitment to expend the contributed funds within the prescribed time is only required for contributions the MRO receives which are deducted by the contributor for income tax purposes under the §170(b)(1)(A), 50% of adjusted gross income limitation rules.[33] The following contributions *do not* require the MRO's commitment to expend such funds by the end of the fourth calendar year after the year of the gift:

- cash or property contributions deducted for individual income tax purposes under the 30% of adjusted gross income limitation of §170 (b)(1)(B);
- contributions of appreciated capital gain property deducted for individual income tax purposes under the 20% of adjusted gross income limitation of §170(b)(1)(D);
- the amounts paid to the MRO under the estate and trust income tax unlimited deduction provisions of §642(c);
- a charitable gift during lifetime which is not deducted by the donor for income tax purposes, but which is deducted for gift tax purposes under §2522 (there is no limit on this deduction); and
- a charitable gift at death which is deductible for estate tax purposes under §2055 (there is no limit on this deduction).

An individual's lifetime contributions to an MRO during any year may be deductible for income tax purposes under more than one of the different subsections of §170(b). For example, cash gifts may be made equal to the 30% limit and additional cash gifts up to 20% more under the 50% limit. Excess contributions over these percentage limits may be carried forward as income tax deductions for up to five years.[34]

The MRO can be started and funded, in whole or in part, during a founder's lifetime. The founder does not have to delay the start, or even the major funding, until death. For all practical purposes, a lifetime gift to an MRO which is not deducted for income tax purposes has the same gift and estate tax effect on the donor as a gift to the MRO at death.

[31] Regs. §1.170A-9(c)(2)(viii).
[32] *Id.*
[33] Regs. §1.170A-9(c)(2)(i).
[34] §170(d).

COMPARING AN MRO WITH A PRIVATE FOUNDATION

The following chart compares the advantages and flexibility of an MRO with a private foundation.

Subject Matter	Foundation	MRO
§4940 - 2% Excise Tax on Investment Income	Yes— 2% annual tax	No
§4941 - Taxes on Self Dealing	Yes — Severe penalties	No
§4942 - Taxes on Failure to Distribute Income	Yes — Annual minimum distributions 5% of fair market value of foundation assets— Severe penalties.	No—But must expend annually for medical research 3.5% of investment assets
§4943 - Taxes on Excess Business Holdings	Yes — Severe penalties	No
§4944 - Taxes on Investments Which Jeopardize Charitable Purpose	Yes — Severe penalties	No
§4945 - Taxes on Taxable Expenditures	Yes — Severe penalties	No
Contributions of Appreciated Capital Gain Property	Not deductible unless the private foundation makes almost immediate distributions of 100% of contributions (A special deduction for gifts of "qualified" appreciated stock in a public corporation terminated December 31, 1994)	Deductible the same as contributions to a public charity

LIFE INSURANCE AND WEALTH REPLACEMENT IN CONJUNCTION WITH AN MRO

There has been a great amount of advertising and sales promotion of so-called "wealth replacement" techniques. These are almost all designed around the purchase of life insurance in life insurance trusts so that the death proceeds are not subject to estate taxes. Often the policies are second-to-die policies which cost much less than single life policies. Although some or many of the selling approaches of the promoters of these techniques are very aggressive, it must be understood that their basic tax planning is correct.

Planning with life insurance in trusts for the family *does* replace wealth, and when properly structured *the insurance proceeds are free of estate taxes.* The gifts to the life insurance trusts of money for premium payments are subject to gift tax. However, with proper planning and analysis, the gift tax can be lowered substantially, or, in some instances, even eliminated. For very large insurance policies the gift taxes can be substantial. However, a well thought out wealth replacement plan can save a family massive amounts of

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estate and generation-skipping transfer taxes, even if gift tax payment is unavoidable.

In funding an MRO during life, much of the funding can be done with contributions to the MRO which are deductible for income tax purposes. (See the various deductible provisions of the Code discussed above.) The income tax savings from those deductible contributions can provide funds for the insurance premiums and, often, enough for the gift taxes on the funding of the insurance trust. For example, a husband and wife each age 60, at standard nonsmoker rates, can purchase second-to-die life insurance of $10,000,000 for a projected $150,000 to $200,000 of annual premium for a planned 10 years. This large difference in premiums relates to the type of insurance purchased, such as universal on the lower end and whole life on the higher end. There are many variations possible and this simplistic illustration is to show the dramatic results of a life insurance investment tied in with funding an MRO. Ten million dollars of insurance proceeds, free of estate taxes, is only an example. It could be any other amount, say $5,000,000 or $50,000,000. The principle is the same.

Contributions to an MRO of $1,000,000 per year of appreciated property in combinations deductible under the 20% limit and under the 30% limit for 10 years, if fully deductible for income tax purposes, will save around $4,500,000 in income taxes for a taxpayer in the top income tax brackets over the 10-year period. This $4,500,000 will be available for insurance premiums and gift taxes. Assuming premiums of $175,000 per year transferred by gift to an insurance trust and no use of the $600,000 unified credit or the $10,000 annual gift tax exclusion, the federal gift taxes over the 10 years on $1,750,000 will approximate $680,000. Result: The MRO is funded with $10,000,000; income tax savings are $4,500,000; life insurance premiums are $1,750,000; gift taxes are $680,000; and the Insurance Trust for the children will have $10,000,000 in trust, free of estate taxes on the second death. And this $10,000,000 can also be free from generation-skipping transfer taxes if the spouses' GST exemptions are properly allocated. The parents still have $2,070,000 of cash in tax savings from the income tax deductions that they can give to the MRO or to other charities of their choice. The author of this article does not sell life insurance. But its use in this type of planning must be considered seriously. It's benefits are very obvious.

Another creative use of life insurance is to make cash contributions to the NRO under the 30% limit and have the MRO buy life insurance on the founder. This results in deductible life insurance premiums with the MRO as both the owner and beneficiary of the policy.

In the example set forth above, the founder would contribute $1,750,000 of premiums to the MRO over 10 years at a net cost of $1,060,000 and the MRO would end up with $10,000,000.

CONVERTING A PRIVATE FOUNDATION TO AN MRO

An existing private foundation can convert, in whole or in part, to an MRO. A private foundation that wishes to convert entirely to an MRO can do so by amending its charter documents to provide that its principal purpose will be the conducting of medical research. It would make its arrangements to function with a non-profit hospital and then amend its charter documents and make application to the IRS for qualification as an MRO. Basically, the same application for MRO qualification would be filed as would be filed for any new MRO. If the converted private foundation to MRO does not demonstrate to the IRS that it is thereafter meeting the requirements of the continuous active conduct of medical research and expending 3.5% of its endowment annually, then it would be treated as a private foundation, effective from the date of its organization.[35]

Similarly, a private foundation may take a part of its endowment and transfer those assets to a newly formed MRO which it creates as a spin-off of the private foundation. For example, assume a private foundation with $100,000,000 in assets transfers $60,000,000 to a new MRO which the private foundation creates. Assuming the charter documents meet the organization tests and the activities of the new MRO meet all of the ongoing activity tests and operations tests in conjunction with a hospital, then the MRO, as a separate entity, is subject to all of the MRO rules, benefits, and detriments. An advance ruling from the IRS should be obtained before taking the initial steps in either of these situations.

CONCLUSION

Non-profit hospitals should study the possibility of establishing a program to encourage wealthy individuals and families to establish MROs that become associated with the hospitals to help fund the hospitals' ever-increasing research needs. Non-profit hospitals should start their planning now. This is a relatively untouched source of research funding that will become even more important in today's changing financial climates.

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[35] §509(a)(1); Regs. §1.509(a)-2(a), (b).

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